REDEFINING THE SOCIAL COMPACT OF U.S. BANKING

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Good morning! It is a pleasure and an honor to participate in this conference on restructuring the U.S. banking industry. I think that, as the theme of this conference implies, we stand at a watershed in the evolution of banking in this country. The process of change was initiated by competitive challenges from outside the industry in the extraordinary interest rate environment of the 1970s. It has gathered momentum as competition from outside the country--in the emerging global marketplace--further tests banks' ability to adapt and succeed. A less discussed, but no less important, part of this sea change in banking is the increasing role banks are being asked to play in addressing the financial aspects of social issues like discrimination and poverty.

Together these changes amount to a redefinition of the social compact that has been expressed in U.S. banking regulation since the 1930s. That compact originally gave banks privileges like their charters and deposit insurance in exchange for increased regulation to promote safe and sound banking practices. When it became clear in the late 1970s that this arrangement was no longer serving the interests of banks and consumers as well as it once had, Congress began to enact legislation expanding banks' privileges and rolling back regulatory restrictions. At the same time, however, banks were given increasing responsibility for consumers' rights in banking relationships ranging from credit access to funds availability and electronic transfers.

As we enter the 1990s, we still need to draw together numerous loose ends in this effort to recast the privileges and obligations of banks. New sources of competition in the globalizing market call for further dismantling of product and geographic restrictions on U.S. banks. This is a job I hope Congress will undertake by repealing Glass-Steagall restrictions and enacting nationwide interstate banking with all due haste. For their

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part, bankers need to abandon the mindset that comes from 50 years of government protection and adapt to the rigors of the marketplace. They also must show good faith by focusing more senior-level attention on programs designed to fulfill the spirit of consumer regulations instituted in the past 20 years. This morning I will outline some of the steps I think policymakers and the banking industry should take in pursuit of these interests. Let me first set the stage, however, by describing the social compact of U.S. banking and how it should be restructured to match present realities.

The Social Compact in U.S. Banking

What I have called the social compact among consumers, bankers, and legislators aims to provide certain subsidies in pursuit of a more stable financial system. However appropriate it may once have been, the arrangement as it is now expressed in product and geographic regulations reflects U.S. financial and economic circumstances of the 1930s and not the 1990s. With the widespread bank failures of the Great Depression, many important banking restrictions were enacted in an attempt to right perceived wrongs. It was believed--though never conclusively proven--that banks' securities dealings contributed to the stock market collapse of 1929 and the economic contraction that followed. Thus the Banking Act of 1933, sometimes known as the Glass-Steagall Act, prohibited commercial banks from investment-banking activities. It also disallowed interest on checking accounts, and placed ceilings on the interest rates banks could offer for time deposits. In addition, the act instituted the FDIC to reduce the likelihood of depositor runs.

As long as interest rates remained relatively stable, as they did for about 30 years, banks were quite comfortable within their regulated preserve. By the mid-1970s, though, advances in technology and communications along with soaring inflation and interest rates fostered disintermediation and generally tilted the playing field to the disadvantage of banks. Under such conditions, the major provisions of 1930's banking legislation have

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proven either outmoded or, in the case of deposit insurance, in need of revision. The banking legislation of 1980 and 1982 phased out interest-rate ceilings and permitted depository institutions to offer NOW accounts. However, the addition of other powers that would have allowed banks greater diversification has not followed. Moreover, banks are still hampered in geographic expansion by a hodgepodge of state and federal regulations, even though some progress has been achieved through the "back door" of regional compacts. Thus, deregulation has not gone far enough to allow banks to match the products and services offered by their nonbank competitors.

Meanwhile, as technological advances speed us toward a 24-hour-a-day global financial market, U.S. banks must contend with foreign providers that have fewer constraints on the scope of their business activity. What is more, the European Community's market unification will escalate these competitive pressures on our banks, and that development is less than three years off. As barriers to international flows of capital, goods, and services are lowered in the EC, we can anticipate extensive consolidation among banks as within other industries there. Giant pan-European corporations are likely to seek banks large and diverse enough to provide one-stop shopping for all the services they require. The same will be true of U.S. businesses which penetrate the EC market.

Current product and geographic restrictions in this country prevent U.S. banks from expanding their operations in scale and scope to match the potential growth of their European counterparts. Most foreign banks already have considerably greater latitude in the types of activities in which they can engage than do ours. Banks in West Germany, for example, can hold equity positions in private companies while banks here cannot. Moreover, it appears that EC banks will soon be able to cross international boundaries in Europe with much greater ease than U.S. banks can cross state boundaries here. Thus our continuing stalemate in regulatory reform could limit U.S. banks' opportunities in the

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potentially fertile post-1992 EC market as well as in other parts of the global market.

As Congress was partially adjusting the scope of banking privileges to developments in the competitive environment in the 1970s, it was also responding to the growing civil rights and consumer movements in this country by enacting legislation to protect banks' customers from alleged discriminatory practices. It passed measures which cover a variety of activities from credit arrangements to timely availability of funds in checking accounts. These regulations seek to delineate acceptable banking relationships for all consumers, but especially those who may have been denied access to financing in the past. Many of these regulations have called for considerable adjustment by depository institutions in terms of paperwork and additional personnel.

Whatever inconveniences they may bring about, though, such measures express the public desire that the banking compact evolve alongside other social changes that have been making U.S. business and social structure more equitable. This country's efforts to incorporate women and minorities into its social and economic mainstream stand as a singular commitment. No other nation past or present has undertaken reforms of such magnitude. I believe that beyond humanitarian concerns we will reap rewards in improved competitiveness when these new sources of dynamism develop more fully. The banking industry, along with U.S. industry in general, has risen to the task of opening its ranks to workers from these groups.

Beyond assuring equal access to jobs, however, it is important to position women and minorities to participate more fully in the nation's economy. It still remains difficult for many of them to get over the initial hurdles in purchasing homes and setting up businesses, and there is a need to make a special effort to get capital flowing their way for economically viable activities. In mandating responsibilities like those expressed in the Community Reinvestment Act (CRA), Congress has asked banks to play a part in this effort that reflects the industry's keystone role vis-a-vis the rest of our economy.

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Lawmakers have recognized that isolated projects will neither solve the broad problem nor profit individual banks. Rather, what is needed is an industry-wide involvement whereby financial institutions work together to arrive at the critical mass necessary to make growth in the less-developed sectors of our economy self-sustaining. This kind of macroeconomic approach is the traditional function of the public sector. No individual would undertake to build a highway, for example, even though that individual stood to benefit from the highway along with numerous others. In such cases, government mobilizes the resources to get the job done.

At present, of course, government resources are constrained by fiscal deficits. For this reason, the private sector is sharing more of the costs associated with the public sector's macroeconomic objectives. As the federal government has been less willing and less able to pay for health-care services, for example, employers and their employees in all industries have had to shoulder more of the burden directly. The private sector is also beginning to realize that it must become more involved in education to ensure a continuing stream of qualified entry-level workers. In the same way, we need to apply private-sector energies to extending credit availability and other financial services to those who may need additional startup assistance. Given its unique experience with structuring credit arrangements, the banking industry is the obvious candidate to provide such assistance.

I believe that the macroeconomic approach embodied in CRA and other consumer-oriented legislation is pointing us in a profitable direction and that over time the banking industry will benefit from such efforts along with society in general. However, we will all be frustrated if we expect immediate results. The situation is quite similar to our attempts as a nation to extend educational opportunities to those sectors of society that were once as a matter of course denied access to quality education. Not only must we deal with the immediate problems of imparting knowledge, but we must address the

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implications of a long history of deficient educational opportunities. Thus we have to think in terms of at least a full generation before a payback can be reasonably expected. Likewise, the positive results of community reinvestment and other programs will only come with time.

For the banking industry, however, there is considerable urgency in the need to show some meaningful progress in the relatively short-term. The portions of FIRREA pertaining to public disclosure of CRA ratings and expanded Home Mortgage Disclosure Act data show that lawmakers fully expect depository institutions to begin finding ways to meet the challenge that has been laid down for them. Moreover, members of Congress from time to time discuss additional responsibilities like "lifeline checking" and "truth-in-savings" that may yet find their way into future legislation.

Thus, both the privileges and obligations in our social compact for banking remain in a state of flux. From the industry perspective, there is no doubt considerable interest in obtaining the expanded privileges that would make U.S. banks more competitive while holding further consumer regulations in check. I feel strongly that Congress should grant new product and geographic powers to banks. However, I also feel that the banking industry needs to take steps to enhance the environment that would make greater powers more palatable to legislators and also to convince legislators and their constituents that banks are holding up their end of the social compact. Let me elaborate on how I think Congress and the banking industry should approach these issues.

The Agenda for Policymakers

Beginning with Congress, I feel it is time to revise those portions of Glass-Steagall that keep banks from conducting at least those enterprises that are consistent with their banking expertise. Banks are quite good at processing information on an asset-by-asset or account-by-account basis. These skills could be safely applied to activities that are

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now prohibited--insurance and corporate debt underwriting, for example. The experience of U.S. bank subsidiaries that have handled similar business overseas convinces me that the risks of expanding powers in this direction do not outweigh the benefits. Moreover, it has been suggested that combining insurance services with traditional banking business actually reduces overall risk.

I recognize that this move entails complexities that run to the heart of this nation's financial regulatory structure and to the corporate structure of banks themselves. Who should regulate banks' securities activities? Should they be contained in a subsidiary of a bank holding company where fire walls might keep problems from consuming the entire edifice? Or will U.S. banks remain at a competitive handicap against Europe's "universal banks," which are required to have little or no institutional separation between investment and commercial banking activities? These questions, I admit, are tough ones to answer. But we cannot arrive at answers until policymakers give these matters the attention that reflects their importance to the nation's economic future.

Personally, I feel some of these structural questions would take care of themselves if a way were found to shrink the extent of explicit and implicit federal deposit insurance protection. If limits to the government's--and that means taxpayers'--deposit insurance liability can be firmly established, banks could be freed to do what they wished--subject, of course, to supervisory oversight. We can work to restrict the implicit safety net by ending regulatory forebearance--the doctrine of "too big too fail." Still, even the explicit safety net needs reform too because of the perverse moral hazard incentives deposit insurance creates. By reform I do not mean repeal. Many would argue that deposit insurance has helped stabilize the U.S. financial system. In addition, consumers here seem to want some degree of deposit insurance, though given the fact that the banking industry is in a state of transition, it is difficult to estimate the true extent of demand for insurance. One possibility that warrants study is coinsurance at a level that

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would keep depositors from being wiped out in the event of failure but would give them more incentive to monitor their institutions' performance.

Aside from broadened bank powers, Congress should move directly to nationwide interstate banking. While we will approach de facto interstate banking through the laws of individual states by 1992, this country will still be left with a plethora of different laws and the unnecessary inefficiencies this lack of uniformity creates. Some states still allow cross-state banking only by banks headquartered in states within the same regional compact, and even within such regional compacts the set of reciprocating partners often varies from state to state. Together, broader product and geographic powers could bring new latitude in decisions banks make regarding the size and scope of their operations. It should also allow opportunities for diversification and profit that do not exist today, both for U.S. banks and many businesses.

Finally, I feel capital standards that are adequate with respect to variations in institutional risk should be a prerequisite for broader banking privileges. The risk-based capital standards adopted by international regulators are a positive step, though these remain to be tested. These standards convert on- and off-balance-sheet credit 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 total capital to risk-weighted assets to 8 percent by 1992.

In sum, the task before Congress is to broaden banks' powers to world-class standards while decreasing the public exposure and moral hazard associated with deposit insurance. Legislators need to recognize the increasing costs of inaction and take these steps with all due haste. I see no reason why this reform could not be accomplished in fairly short order. It would help, however, if the banking industry would close ranks around the kinds of proposals I have made.

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Agenda for the Banking Industry

Unfortunately, while many bankers agree individually that such steps are necessary, as a group they have been unable to reach a consensus on what should be done. For example, many bankers clamor for broader powers, but some others resisted the strengthened capital standards that will help make broader powers feasible. Again, bankers claim to desire greater competitiveness, but they have used their clout to keep new competitors from entering their own markets in certain regions. Those regional banking compacts provide a good illustration of the protectionist attitudes that work against progress toward industry reform. In spite of the fact that some larger banks have now for the most part exhausted their avenues for growth within their regions, many have shown little interest in further opening their state boundaries to outside institutions. Of course, not all banks want to open offices in other states. In fact, some institutions are now pulling back from certain areas where they had established a presence. However, it seems to me that the industry's failure to give unilateral support to nationwide interstate banking is sending the signal that it would rather limit its own horizons than accept greater competition.

Such an attitude represents as much a failure of imagination as of ability to compete. Industries that have faced up to outside competition and streamlined their operations in response have emerged stronger than ever. The textile industry in my part of the country is one example. Textiles have become "high-tech." After being battered by cheaper imports, textile manufacturers brought themself back to profitability by adopting productivity-enhancing equipment and procedures. This is the correct--indeed, the only way to succeed in the global market.

In many ways, U.S. banks have shown a great ability to innovate in response to changing market conditions. When interest rates began to drift upward in the 1960s, it was banks themselves, not government regulators, that came up with such ideas as

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negotiable CDs. More recently, banks have countered interest- and exchange-rate risk with new products like swaps and have broadened the pool of potential investors through the growing securitization of assets. Thus I am confident of the industry's creativity. Their record of innovation suggests to me that the industry is fully capable of meeting competitive challenges and has no need to hide behind protective barriers. Instead, bankers need to shake off the narrow ways of thinking that linger from half a century of protection and turn their energies to forging a unified program for progress. If they do not, they risk allowing their competitors to dominate the global banking market.

It is this same sort of creativity that banks need to demonstrate with regard to meeting the consumer agenda that has been articulated in recent years. My hope is that banks would take their cue from the clear signal Congress has sent in the past and get ahead of the curve on this side of the social compact. From the perspective that regulation generally proves more costly than voluntary initiatives, I would like to see us avoid further legislation. It seems to me that CRA, which has become the most visible of consumer regulations in the past several years, offers a good vehicle for demonstrating the industry's commitment to broadening its reach to all segments of this country's banking market. A variety of excellent programs has already shown ways that community reinvestment can meet the needs of low- and middle-income neighborhoods and still prove profitable.

However, such programs require institutions to change their traditional ways of doing business. They have to look at smaller, unconventional arrangements in parts of town they may have ignored in the past. They must find community development organizations to work with. They might well need to get out into the schools and other forums in those areas to help educate future consumers about the options as well as the responsibilities that come along with bank credit and services. However, if senior management becomes involved to the extent that the importance of CRA warrants, I see

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no reason why banks in every community cannot come up with ideas that go beyond merely satisfying the supervisory agencies but also make a positive contribution to their local economies. And since banks' balance sheets ultimately reflect the economic health of the communities they serve, the energy put into community development, if properly channeled, should pay dividends in the future.

Conclusion

In conclusion, I feel that restructuring the U.S. banking industry can be viewed in terms of reshaping the social compact under which banks have operated in this country. We have made partial progress toward changing the prohibitions that were out of sync with the competitive environment in this country, but we need to do more to keep our institutions viable in the global market. In addition, we have spelled out what we expect from banks in terms of responding to consumers' needs, and these obligations need to be woven more firmly into the fabric of banks' daily activities. To these ends, policymakers need to complete the work of deregulation that has stalled since the early 1980s, and the banking industry needs to stop clinging piecemeal to protective aspects of regulation. The industry must also find ways of being more competitive in a free market and more responsive to those segments of the market that have been neglected in the past. It is time for bankers and policymakers to come together and bring our banks into step with the historic changes transforming the world's economic and political landscape.

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