

AGENDA FOR BANKING IN THE 1990s
Remarks by Robert P. Forrestal, President
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Good morning! It is a pleasure and an honor for me to have this opportunity to speak to the Georgia Bankers Association. This organization, which is entering its 99th year, characterizes the strength and stability that runs through the banking community in the state. I found further evidence of those qualities in reviewing a draft of a bank profitability study which my staff is preparing for publication this summer. The study shows that in 1989 Georgia banks once again performed better than the national average and led the Southeast in such measures of profitability as returns on assets and equity and also adjusted net interest margin. In fact, Georgia banks' adjusted margin and interest revenue measures have consistently been the best in this region over the past five years. I would like to congratulate you on this record, which testifies to the efficient way in which you have been going about the business of banking in this state.

In spite of this excellent showing on the part of Georgia banks, however, the banking industry here and in the rest of the United States remains in an uncomfortable state of transition. U.S. banks have confronted competitive challenges from outside the industry and, more recently, from outside the country--in the emerging global marketplace. 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.

Our response as a nation has been to initiate a process of recasting the privileges and obligations of banks, but we still need to draw together numerous loose ends before we can claim success. I envision an agenda for both Congress and the banking industry in accomplishing this task. I hope Congress will do its part by reforming deposit insurance,

repealing outmoded product restrictions, and enacting nationwide interstate banking with all due haste. For their part, bankers need to abandon the mindset that comes from 50 years of government protection. 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 their complementary agendas. Let me first set the stage, however, by discussing what should be done to make banks' privileges and obligations more consistent with present realities.

The Social Compact in U.S. Banking

Our approach to banking in the United States since the 1930s has been to define a social compact among consumers, bankers, and legislators that aims to provide certain subsidies in pursuit of a more stable financial system. (Unfortunately, this arrangement as it is now expressed in product and geographic regulations remains lodged in U.S. financial and economic circumstances of the 1930s and not the 1990s. During recent decades, advances in technology and communications, along with a period of soaring inflation and interest rates, fostered disintermediation and generally tilted the playing field to the detriment of banks. The banking legislation of 1980 and 1982 went part way toward rectifying banks' disadvantages. 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. U.S. banks' opportunities in the potentially fertile post-1992 EC market as well as in other parts of the global market could be limited by the continuing stalemate in regulatory reform that prevents U.S. banks from expanding their operations in scale and scope to match the potential growth of their European counterparts.

I do not want to leave you with the impression that we should seek such reforms only to allow us to grow larger banks in this country. Research at the Atlanta Fed has shown that large banks are not more innovative, and they seem to be losing their productivity edge vis-a-vis foreign banks. Of course, smallness may have its disadvantages too. ^{Recent} The Atlanta Fed's profitability study to which I alluded earlier suggests to me that there may be a threshold--probably around the \$50 million level--below which it may be hard for an institution to remain viable in the contemporary market. However, the resilience that de novo banks have shown in surviving even under adverse conditions demonstrates that small- and medium-sized institutions still have an important role to play. For these smaller banks, an end to anachronistic product restrictions would permit diversification into insurance and real estate operations, for example. State-chartered banks in certain midwestern states, which have been permitted to offer such services for some time, have shown that these activities are not inconsistent with safe and sound banking. Thus further relaxation of existing prohibitions could offer banks across the entire size spectrum greater opportunities for profit while making them more responsive to their markets.

As Congress partially adjusted the scope of banking privileges to developments in the competitive environment, it has also been 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's desire that the banking compact evolve alongside other social changes that have been making the U.S. business and social structure more equitable. 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. 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 strata 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 direct costs associated with the public sector's macroeconomic objectives. For this reason, we have seen a shifting of

social responsibilities like health care and education to the private sector. 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 perspective 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, the kind of results at which we aim will only come with time. Meanwhile, there is considerable urgency for the banking industry 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 federal 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 the agenda I envision for both Congress and the banking industry in approaching these issues.

The Agenda for Policymakers

Beginning with Congress, I feel it is time to revise the 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 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. In the same vein, as I mentioned earlier, there is ample evidence that banks can offer non-traditional forms of retail business now prohibited by federal law--brokering insurance and real estate, for instance--without increasing their riskiness.

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. Numerous difficult questions regarding corporate and regulatory structures remain to be resolved. Personally, though, I feel some of these structural issues 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 forbearance--the doctrine of "too big too fail." Still, even the explicit safety net needs reform because of the perverse moral hazard incentives deposit insurance creates. We need to be assessing a variety of alternatives, from coinsurance and "safe banks" to other concepts that would address these issues.

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. By bringing homogeneity to interstate regulations, lawmakers would improve conditions not only for larger banks that might wish to expand outside the region but for smaller banks as well. The latter could find the value of their charters increased--even if they did not wish to sell them--if more outside banks could be counted among the ranks of potential purchasers.

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 agenda for 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.

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. It is time for bankers to realize that the protectionist stance expressed by those regional banking compacts works against progress toward industry reform. 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.

These anti-free-market attitudes represent as much a failure of imagination as of ability to compete. In numerous 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 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. Its 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 display 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 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.

Again, I am not referring only to the large banks in urban areas, where most of the attention surrounding CRA has been focused to date. In many ways, the situation in rural communities is more critical because poverty is more pervasive in such areas. The future of these communities--and the banks that serve them--may depend to a large extent on the success those banks have in pulling together the resources to stimulate the lower strata of their local economies. Otherwise, they will probably continue to see the unfortunate drain of their most valuable resource: the people, particularly the young and better educated ones, who will leave in search of better opportunities elsewhere.

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.