THE INTERNATIONAL COMPETITIVENESS OF U.S. BANKS

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To the International Advisory Committee of Trust Company Bank
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Good morning! I am pleased and honored to have the opportunity to speak to Trust Company's International Advisory Committee once again. Four years ago I gave you my views on the international monetary and economic situation. Although at that time we all were aware of the increasingly integrated nature of the global economy, few of us would have anticipated the dramatic changes that would reshape the international scene at the end of the 1980s. The accelerated pace of European economic integration in the past two years and the collapse of communism as a viable alternative to free market economies in late 1989 suggest that the process of globalization will continue to gain momentum in the decade ahead.

However, I am deeply concerned that in this globalized market the U.S. banking system, the keystone of our economy, will find itself lacking some of the tools it needs to compete effectively. To ensure that this nation's ability to do business abroad is not compromised by structural weaknesses among our banks, we need to do several things, and do them quickly. These are: (1) Congress needs to free banks to do more types of business and to do business wherever they wish. (2) Congress also should act to return the deposit insurance system to its original intent. Deposit insurance was meant to underwrite the stability of the financial system and not to assure some institutions that they are "too big to fail." And (3) the banking industry must abandon the mindset that comes from 50 years of government protection and adapt more readily to the rigors of the marketplace.

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Today I would like to suggest a strategic agenda, one that will help prepare the U.S. banking system for the challenges of 1990 and beyond. The measures I will outline pertain to policymakers and bankers alike. Let me first set the stage, however, by describing the competitive position of U.S. banks in the current environment.

Regulation and Protection

First of all, I would like to stress that, in general, U.S. banks are in rather good shape, and I expect the industry to remain healthy. Although in excess of 200 banks have failed in each of the past several years, in my view these events have resulted more from a thinning out of the overcapacity that has existed in banking than from any systemic weakness. On the contrary, the industry's record of adaptability suggests to me that for the most part our banks remain well equipped to survive and prosper. One example of a successful banking response to changing market conditions was the emergence of negotiable CDs when interest rates began to drift upward in the 1960s. More recently, banks have countered rising interest- and exchange-rate volatility with new products like swaps and have moved aggressively into other non-interest sources of income. In addition, they have broadened the pool of potential investors through the growing securitization of assets. Such flexibility has led to greater profitability in recent years. Aside from the country's largest banks, which continued to be hurt by their exposure to LDC debt, U.S. banks in most other size categories posted their third consecutive year of increased profitability in 1989, according to recently published Atlanta Fed research. Thus I am confident and optimistic about our banking industry's ability to evolve new ways to meet competitive challenges.

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However, the playing field on which banks attempt to compete, not only with domestic challengers, but increasingly with foreign firms, is still tilted to their disadvantage by the incomplete state of deregulation in this country. Federal banking legislation of 1980 and 1982 went part way toward revising regulations that were out of step with developments in the marketplace. These steps were not followed by the addition of other powers that would have allowed banks greater diversification, though. And 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 interstate banking compacts. Thus, deregulation has not gone far enough to allow banks to match the products and services offered by their nonbank competitors.

Foreign providers, too, have fewer constraints on the scope of their business activity. With technological advances speeding us toward a 24-hour-a-day global financial market, U.S. banks will have to contend more and more with this outside source of competition. 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 operating in the EC market.

Current product and geographic restrictions in this country prevent U.S. banks from

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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 even underwrite equity issues. 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 threatens to limit U.S. banks' opportunities in the potentially fertile post-1992 EC market as well as in other parts of the world. This situation may appear to be a matter of concern only to banks, or even to big banks, but the scope of its adverse impact is much broader. Small and medium-sized firms in the United States may be at a disadvantage in expanding internationally because their financial intermediary cannot provide the same range of services that their European competitors can obtain through their banks.

Clearly, then, we all need to be concerned about the competitive disadvantages imposed on the U.S. banking system by our current regulatory framework. From what I have said so far it might seem that we need to mandate a further regulatory rollback. Unfortunately, there is one other, quite different problem that must be resolved first, in my opinion. That is deposit insurance, which has effectively placed the full faith and credit of the U.S. government behind our banking system. With the doctrine of "too big to fail," deposit insurance has been extended to an implicit safety net protecting all the activities of a bank. During the last decade or so regulators on several occasions came to the conclusion that it was cheaper to use the insurance fund to pay off uninsured as well as insured holders of bank liabilities than to let a large bank's

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failure threaten the entire banking system.

More recently, the thrift industry fiasco also made it apparent that deposit insurance carries the same type of moral hazard that has been identified with respect to other types of insurance. In this case, the fact that institutions were insured against loss led them to become involved in riskier activities than they would have had they not been insured. At the same time, the security offered by explicit and implicit insurance made depositors, shareholders, and creditors less likely to impose market discipline on bank management by withdrawing their funds when an institution's activities became questionable. In all these ways, deposit insurance has come to insulate depository institutions from the sort of market feedback that prevails in other industries.

Thus, I believe we need to start using a new metaphor to better understand the banking industry's weaknesses. We must think of banking as an industry that is protected as much as it is regulated. This remains the case even though some regulatory subsidies--such as the interest-rate ceilings that placed a cap on banks' cost of funds--have been removed. As a protected industry, banks share some of the symptoms of competitive atrophy that other protected industries display. Such industries tend to become ensnared by the safety net that was spread out to protect them. They lose the incentive to make improvements that would improve their performance and reduce their need for special treatment. Banks in some areas have also used their influence with state legislatures to slow the pace of change in removing interstate banking prohibitions, thereby keeping their markets protected from outside competition. In this regard,

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policymakers and the banking industry both have work to do in overcoming the inertia that now besets the movement toward industry restructuring. I would like to turn now to look at the strategic agenda I envision for each group.

The Agenda for Policymakers

Beginning with Congress, I believe legislators should adopt a two-pronged approach that simultaneously reins in the regulated--and protected--dimensions of the U.S. banking system. First, in terms of product and geographic regulation, we need to let banks meet their domestic and international competitors on a more equal footing. At the same time, the original intent of protecting limited amounts of consumers' funds through deposit insurance must be restored. In place of the broad insurance safety net that now exists, we should promote safety and soundness in banking by alternative means such as adequate capital standards, less regulatory forbearance, and greater market discipline. Let me elaborate briefly on ways Congress might strike this balance between regulation and competitiveness.

To begin with, I think Congress needs 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. Moreover, it has been suggested that combining insurance services

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with traditional banking business actually reduces overall risk. I recognize that this move entails complexities which 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," with their minimal separation between investment and commercial banking activities?

Finding answers to these thorny questions would be somewhat easier if we increased the industry's capital cushion. 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.

Aside from broadening bank powers, Congress should move directly to nationwide interstate banking by repealing the McFadden Act. 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

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opportunities for diversification and profit that do not exist today, both for U.S. banks and many businesses.

However, no expansion of commercial powers should come without reforming federal deposit insurance. 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. Nonetheless, we must make some fundamental changes. First, we need to restrict implicit protection by ending regulatory forbearance--the doctrine of "too big too fail." Indeed, we need to go farther and implement measures that foster prompt closure of troubled institutions. Here, I think we must let markets--the financially sophisticated holders of liabilities like stocks and bonds--take prime responsibility for monitoring institutions' health and pulling out when the risk becomes too great. Regulators and depositors will inevitably move too slowly and judiciously to contain the escalation of risky ventures in a troubled institution.

While depositors, in my view, should have less responsibility than holders of banks' equity and debt, even the explicit safety net of deposit insurance needs reform because of the perverse incentives deposit insurance creates, as I have already described. One possibility that warrants study is coinsurance at a level that would keep depositors from being wiped out in the event of failure but would give them more incentive to be concerned about their institutions' performance.

In sum, the task before Congress is to broaden banks' powers to world-class standards

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while decreasing the public exposure and moral hazard associated with deposit insurance.

Agenda for the Banking Industry

The Banking industry must also act by closing ranks around the kinds of proposals I have made. Far from showing a united front, the various industry lobbying groups send mixed signals to policymakers. For example, on one hand, many bankers clamor for broader powers, but on the other, they resist the strengthened capital standards that would 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 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, as I mentioned earlier, U.S. banks have shown a great ability to innovate in response to changing market conditions. This enduring creativity suggests to me that the industry is fully capable of meeting competitive challenges and has no need to hide behind protective barriers.

Conclusion

In conclusion, I feel the market for U.S. banks--and hence for all American businesses--is

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potentially much greater as the global market evolves. However, the industry must prepare itself for broader competitive challenges as well. Banks need to end their opposition to the dismantling of government protection and find ways of being more competitive in a free market. At the same time, policymakers must break their own gridlock and renew efforts to complete the job of deregulation. It is clear what needs to be done--reform deposit insurance, end the remaining constraints on interstate banking, and repeal Glass-Steagall. It is also clear that developments like Europe 1992 make the time for doing it short. U.S. banks need to be ready for the post-1992 global market, and U.S. industry needs our banks to be ready for it. 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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