THE U.S. BANKING SYSTEM IN TRANSITION
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Good afternoon! I am pleased and honored to be a participant in this conference entitled "Banking at the Crossroads." I like to think of our banking system as not, perhaps, so much at a crossroads, with all of the "do-or-die" connotations that image conveys, but rather undergoing transition. It is changing from an industry in which public sector subsidies and controls have played too great a role to one that I believe must become more subject to market competition. This transition is part of the worldwide trend toward a free market of global scope. The increasing ease with which capital can flow across international boundaries--prompted by advances in automation and communications technology--has reduced the effectiveness of many government-imposed structures attached to U.S. banking since the 1930s. Yet residuals of past legislation continue to compromise the ability of U.S. banks to compete not only against international, but also domestic providers of financial services.

I am not sure precisely what structural reforms will enhance U.S. banks' competitiveness. I can say with certainty, however, that the future structure of U.S. banking needs to foster stability in the nation's financial system while providing safe and efficient services for the small saver. Thus, we need to make the transition toward a competitive system that can face the test of market discipline but with appropriate regulation to ensure that certain social goals are met. Unfortunately, this transition has been temporarily stalled because some issues have proven to be more intransigent than we at first thought. One of the chief sources of gridlock is deposit insurance, and working through the complexities of this issue promises to keep us in a state of transition for several years to come. In the interim, I think we need a strategy that can be put in place in relatively short order to ease the uncertainty of the necessary transition period, and I would like to propose one way of doing this. First, we need to bolster the cushion available to the insurance fund by requiring higher capital. Second, we must enhance bank supervision and institute procedures for resolving problems promptly. I would like to elaborate on these ideas and then talk about what I believe we want our banking system to do in a globally competitive environment. Before I address these points, however, I will begin with a brief overview of the dilemma of deposit insurance.

The Dilemma of Deposit Insurance

The U.S. deposit insurance system poses a true dilemma because it has some very useful features that I believe we want to preserve along with some counterproductive aspects that need to be eliminated. On one hand, the deposit insurance system--along with the lender of last resort function of the Fed's discount window--has done a good job of fulfilling the chief objective of those who devised it. It has shielded the banking system from the kind of systemic runs that can cripple the nation's economic activity. In addition, deposit insurance has taken on the further function of providing security for small savers. I daresay that even industry specialists, let alone individual depositors, have a difficult time sorting out the complexities of today's financial services market.

The less productive side of deposit insurance became apparent after other government banking measures that protected banks from competition and gave their charters value were dismantled at the beginning of the past decade. These included geographic restrictions that limited entry of competition and interest rate ceilings, particularly the zero rate on transactions accounts balances, that bolstered profit margins. The protected banking market began to erode in the 1960s with the development of a competitive Eurodollar market for deposits and some relaxation of bank charter restrictions. Later on, advances in technology allowed nonbank providers of financial services to offer stiff competition for banks' business. Thus it was no longer possible to protect banks by in essence limiting their competition. Both banks and nonbanking intermediaries began to press for a more level playing field, although, quite naturally, they had different interpretations of what "level" meant. These pressures led to the legislation of 1980 and 1982 that allowed depository institutions to offer some new products and eliminated interest rate restrictions. Deposit insurance was left intact, though, and coverage was even boosted from $40,000 to $100,000 per account.

The preservation of deposit insurance even while other rigid elements of the system that had enhanced profits were being eroded aggravated a problem that is inherent to certain insurance systems, especially those in which premiums are unrelated to risk. That is the phenomenon known as moral hazard, whereby the existence of insurance leads to a greater tendency to take the very risks insured against. With their franchises less protected and profit margins thinning in the face of nonbank competition, the most hard-pressed depository institutions had more incentive to gamble on riskier assets in the hope of making up a lot of ground in a hurry. Even though their capital was inadequate to offset their bets, they knew that should they lose deposit insurance would back them up. In this way, deposit insurance became a substitute for capital in shoring up the charter value of such institutions. The ultimate backers--the taxpayers--have, of course, been called upon for assistance in the case of the thrift industry. As depositors, though, many of those same taxpayers have been buoyed by the explicit guarantees of deposit insurance, and they have long since relaxed their vigilance over the condition of the institutions in which they placed their funds. Unfortunately, we have seen that other creditors who are in principle not insured nonetheless enjoy implicit protection as well. They too have reduced incentives to monitor the actions of bank managers.

Thus if we are to have a more market-oriented financial services industry, moral hazard needs to be reduced by better defining the limits of the deposit insurance safety net. However, several considerations prevent us from making quick changes to the system. First, any decisions we make should preserve the deposit insurance system's positive contributions to banking stability and consumer confidence. Second, the present level of implicit and explicit deposit insurance has long been factored into the market value of depository institutions and the financial decisions of millions of households. Thus, attaining the kind of system we ultimately desire could involve costs in money and time, and we need to allow for both during a period of transition.

A Strategy for the Transitional Period

Clearly, we should devise a strategy for making this transition, preferably one that contributes to a long-term solution to current inadequacies in the banking system. For one thing, we need to create a better cushion for the deposit insurance system to protect taxpayers from losses. A start would be better capitalization and prompt resolution of situations in which risk is increasing. The latter actions could be triggered with reference to capital levels. We have already begun to move in the direction of higher capital ratios by agreeing among international regulators to institute risk-based capital standards, which will be phased in beginning at the end of this year. Most U.S. institutions have already made the adjustments required for the fully implemented standards of 1992. However, I believe that even higher minimum levels of capital are called for, especially for institutions that want to take on additional activities.

Increased capital is attractive for a number of reasons. First, we are attempting to repair a system that has encouraged bank owners to take more risk than would otherwise be the case and to substitute deposit insurance for capital. Thus, it makes sense to gradually reverse that trend by requiring more capital. Higher capital levels would also create a larger buffer between mistakes bankers make and the need to draw down the insurance fund while at the same time moving us in the direction of greater market discipline. Banks would have to be able to convince market participants that their investments would be rewarded. Those that are unable to do this would obviously not be able to expand.

The corollary to higher capital is regulatory oversight capable of forcing institutions to take immediate steps, including liquidation when necessary, when their capital ratios fall below established thresholds. Under the current framework, banks can protest a regulator's decision of insolvency over too long a period of time. Thus, I would like to see regulators adopt a more formal program of progressive action on the basis of capital levels. Such a program could be instituted quite readily based on the risk-based standards that will shortly go into effect and later ratcheting up the thresholds as higher capital standards are set. Of course, attaining higher capital levels is not without its costs. Several of our large banks have had their debt ratings reduced, and the current market yield on this debt has risen. Many bank stocks have taken a beating. Another potential criticism is that U.S. banks might find themselves at a disadvantage vis-a-vis foreign banks that only adhere to the minimum agreed standards. Still, these concerns must be balanced against the need for some sort of reform to relieve the pressures of the present. I think higher capital and timely resolution of failed institutions can provide that relatively short-term relief and at the same time serve as a plank in the ultimate restructuring of the banking system.

Moreover, I feel that the issue of U.S. banks' global competitiveness should be viewed from a longer term perspective. In recent years, many have pointed to the absence of U.S. banks among the world's largest institutions as evidence that banks here were losing their competitive edge in the international market. Of course, these comparisons are usually not adjusted for currency values, which have diminished the relative size of U.S. banks' assets following the descent of the dollar on foreign exchange markets over the past five years. Be that as it may, the institutions that now dominate the lists of asset-size comparison--those of Japan and Western Europe--operate under systems having many of the features U.S. banks have already left behind. They belong effectively to national cartels, as U.S. banks in many ways did until the mid-1970s. All this will change for European banks in 1992, at which point the systems of individual countries may well be tested in some of the ways ours has recently been. Their deposit insurance systems will need to be made more explicit, for example, when their current implicit governmental guarantees of solvency are altered by cross-national banking arrangements. Japanese banks already appear to have entered a phase of retrenchment in anticipation of the new international capital standards, perhaps shifting away from their growth strategy toward a greater emphasis on profitability.

Thus, we should not panic at the position of U.S. banks among the world's financial institutions in terms of present measures of size. Instead we should think of ourselves as taking a leadership role, establishing a model of a banking system that can provide effective service in a global marketplace. This is all the more incentive for us to carefully consider what we want the post-transitional U.S. financial system to look like. I would like to round out my comments with a few ideas on features I believe such a system should possess.

The Shape of Banking to Come

I think that we want to come out of our transitional period with an industry that is a safe and sound intermediary--one that unsophisticated investors can use with confidence and yet that is free from the kinds of risk-incentives that exist today. The higher capital standards and lessened regulatory forbearance I have proposed should take us a long way toward these goals. However, I think we should preserve deposit insurance after we redefine its scope. There are several worthy concepts for doing this, including narrow banks, co-insurance, and risk-based insurance premiums. I am sure that the Treasury Department's forthcoming study of deposit insurance--a requirement of last year's banking act--will thoroughly assess these and other alternatives.

One proposal for assisting regulators in deciding at what point to take action on a troubled institution involves the creation of a class of puttable subordinated debt. Large banks would be required to issue bonds whose payment is junior to the banks' other liabilities but whose owners are allowed to request redemption at any time. Banks would have 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. The market for this subordinated debt would thus become a source of discipline for bank managers and provide regulators with signals of investors' judgment regarding a banks' health.

We also need to aim for an industry that following the removal of existing government subsidies is competitive with other domestic and international providers of financial services. To accomplish this, we need to free banks to engage in a greater range of activities if they choose. After bolstering banks' capital and narrowing the deposit insurance safety net we should allow a general expansion of bank powers. This includes, for example, underwriting corporate debt and equity issues, activities in which the Fed has begun to allow very well capitalized holding companies to engage on a case-by-case basis. For that matter, there is no reason why a bank holding company should be prohibited from engaging in any business consistent with its expertise if the lines between insured and uninsured activities are properly drawn and if capital is adequate. By opening up the scope of activities banks are permitted to undertake, the playing field would become level at last.

One other change that could enhance banks' competitiveness would be the institution of nationwide interstate banking. We are already on the way to interstate banking as individual states choose to open their borders to outside organizations. However, Congress could--and should--cut the Gordian knot and take us directly to a nationwide interstate arrangement. Such a move would allow banks to diversify geographically and reduce the risks associated with downturns in their local markets. It would also lower the costs of redundant corporate structures and other inefficiencies imposed on banks by the need to respond to 51 separate sets of state laws as they do now. I see no danger in going to nationwide interstate banking immediately.

What will an industry that is restructured in the ways I have mentioned look like? This is difficult to say, but I believe we should see banks populating pretty much the range of sizes we have today--from community banks to money center giants. I think that we will still need smaller sized banks to meet the specific needs of home owners and small businesses in their local markets. At the same time, we may see new kinds of institutions specializing in credit evaluation and loan origination as well as others that make their money from packaging and selling loans. Meanwhile, more of our larger banks are likely to become full-fledged financial service holding companies, providing one-stop shopping for the financial needs of domestic customers and multinational firms alike.

Conclusion

In sum, I hope to see within the coming decade the emergence of a more competitive U.S. banking system undergirded by adequate capital standards and decisive regulatory action.

I would like participating institutions to be able to operate nationwide and expand in scope to offer whatever services they can efficiently provide. I believe we are in a period of transition in moving toward such a system, and that this period will continue for some time while we work through the inherent weaknesses in the present system, particularly those surrounding deposit insurance. At the end of that period, though, I am confident we can emerge with a financial industry structure that can serve as a model for other countries as they too adapt to the demands of the global marketplace.