FINANCIAL SERVICES AND DEFENSE: TWO INDUSTRIES IN TRANSITION

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To the U.S. Army Materiel Command
and the American Defense Preparedness Association
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Good afternoon! I am pleased and honored to appear before this joint meeting of the U.S. Army Materiel Command and the American Defense Preparedness Association. These annual conferences in Atlanta have played a key role in sustaining our nation's defense capacity by nurturing a synergy between the private and public sectors. We have recently seen how well this public-private partnership works, as the superior abilities and equipment of U.S. forces brought swift victory in the Persian Gulf. It is fortunate that such a strong relationship has been developed because new challenges are on the horizon. Indeed, fundamental changes in foreign relations, combined with a

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pressing need to bring the huge federal budget deficit under control, have already begun to precipitate a major transition in the defense industry. Similarly profound changes are underway in the U.S. financial system. The resulting uncertainty has raised questions about financing prospects, especially for capital-intensive industries like defense.

This afternoon I would like to give you an overview of the transition taking place in the financial services industry, which in many ways is similar to that in the defense industry. By highlighting the parallels I hope to give you a perspective from which you can better gauge the likely effect on capital formation generally and on your industry specifically.

Parallels Between the Financial Services and Defense

Industries

The fundamental similarity between the long-term transitions under way in the defense and financial services industries arises from their intimate links to government and the cost of those links to taxpayers. Both industries have grown large through their special relationship with the public sector. Now, however, the size of current and potential expenditures, along with more general concerns about the federal government's huge budget deficits, are forcing policymakers to take a fresh look at commitments to both industries. The defense industry, of course, is directly influenced by government procurement decisions, and spending on defense has long been the largest single outlay in the federal budget. Last year, however, the federal budget accord established defense spending as one of three

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discretionary categories, each of which has an individual spending limit. This approach implies that defense spending cannot grow at the expense of other programs, as it could under previous deficit-reduction arrangements. Whether or not the pool of funds dedicated to defense will eventually shrink in real terms ~~remains to be seen~~. Still, it appears that domestic spending on defense could be significantly limited.

Banking has also received several types of support from the public sector over the past 50 years, though these have been more indirect than those in defense. They have included interest-rate regulations, protection from competition, and deposit insurance. The first two types of support are no longer as important as they once were. Interest-rate regulations on all but commercial demand deposits were

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eliminated in 1980, and competition has increased through the expansion of bank-like services outside the confines of banking regulation. Money market funds have attracted many depositors who once relied on banks. Meanwhile, financing through subsidiaries of manufacturing firms and direct issues of commercial paper for larger businesses have been able to make considerable inroads into a traditional and important niche for bank lending. Thus, banks no longer enjoy a protected market for their services. Nevertheless, the third support remains. A substantial public subsidy continues in the form of deposit insurance. Deposit insurance provides a government guarantee for banks' primary source of funding--so-called "core deposits." This is a benefit no other capital market intermediary receives.

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Implicit government subsidies for financial institutions carried few visible costs to the public until the 1980s. However, the savings and loan debacle dramatized the serious flaws in the deposit insurance system. Deposit insurance was designed to protect the banking industry from the kind of systemic runs--on weak and sound banks alike--that once crippled the nation's business activity. It has performed this function well, but in so doing it also reduces the incentive for depositors to monitor the soundness of the banks where they deposit their funds. Even larger depositors with amounts that are technically uninsured as well as other creditors have relaxed their vigilance when they have believed that a bank is "too big to fail." Because they are shielded from true market discipline by this explicit and implicit safety net, financial institutions can take on added risk without paying

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depositors and other creditors a return that truly reflects that added risk.

The inducement to greater risk-taking that the deposit insurance safety net brings does not greatly affect well capitalized institutions--they have too much to lose. However, it is especially strong for those institutions on the edge of failure. In these cases, the higher gains associated with higher risk go to equity holders, while the losses are borne by the insurance funds and, ultimately, by the taxpayers. The banking industry has so far escaped major damage from this perverse effect of deposit insurance, in no small measure because banks are generally better capitalized than S&Ls. However, the deposit insurance subsidy continues to attract still more institutions to an already overbanked market. The

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resulting overcapacity dampens profitability for everyone because there are simply not enough good loans to go around. In this way the insurance system is inadvertently helping to push more banking institutions toward difficulties.

Coming on the heels of the expensive S&L industry collapse, weakening profits among commercial banks have generated considerable concern among policymakers. In addition, the current need to recapitalize the Bank Insurance Fund has kept the financial services industry in the eye of the budgetary storm. It is likely that lawmakers will seek to reduce the safety net of deposit insurance as a way of minimizing future losses associated with these contingent liabilities.

Thus, both bankers and defense contractors must prepare themselves to be less dependent on the U.S.

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government. For both, greater diversification is probably a pragmatic strategy. Offering new products is a less complicated prospect for the defense industry, where many manufacturing and even consumer-oriented products can be spun off from present products and operations. In contrast, banks are forbidden by law from engaging in nonbanking activities. I advocate an expansion of banks' product lines into areas like securities-underwriting. In my opinion, however, any new powers should come only after regulators are assured that capital levels realistically reflect each institution's riskiness. Until this condition is met, it makes no sense to allow banks to expand beyond their present range of activities.

In addition to diversification, some consolidation needs

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to take place, in the banking industry. In addition to subsidized deposits, regulations that have prohibited interstate banking have left this country with far more banking institutions than most other industrialized countries. Moreover, because banking is regulated, the closing of a bank has to be supervised. Thus, even when an institution is not making enough to survive, it might have to stay in business while exit procedures are under way. This, too, adds to overcapacity. Clearly, some compression of these numbers is called for, but how to achieve this in an orderly fashion has yet to be determined. The defense industry may not have a problem of this dimension. Nonetheless, some consolidation could be inevitable. The budget accord now in effect caps defense spending in absolute dollar terms. Thus, any new projects will have to be funded at the expense of existing

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ones, and this implies intensified competition among contractors. Increased competition may eventually leave the defense industry with fewer vendors holding larger shares of the business.

Public Policy Role in Banking

In sum, defense and banking are undergoing transitions driven by the likelihood that federal government support will be more limited in the future. Both must look for ways to diversify, and both could experience some consolidation. Of course, in the case of banking the needed changes cannot come through private-sector initiatives alone. Policymakers need to enact some major reforms of the industry's regulatory framework. In addition to the higher capital requirements that I mentioned earlier in association with

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diversification, these reforms include reining in the deposit insurance safety net, elimination of regulatory forbearance, and further deregulation of geographic and product restrictions.

As I see it, a basic ingredient in the approach to many of the banking industry's difficulties is to increase the stake banks' owners have in the prudent management of their institutions. One important measure along these lines is capitalization. Regulators began phasing in higher capital standards at the end of last year, and most U.S. institutions have already made the adjustments required for the fully implemented standards of 1992. However, I believe even higher minimum levels of capital are called for, especially for

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institutions that want to take on additional activities as part of their transition to more market-oriented activities.

Higher capital levels would minimize the need to draw on the insurance fund by creating a larger cushion against mistakes even the best bankers can make. Enhanced capital also helps move us in the direction of greater market discipline, as do similar measures like special classes of subordinated debt that holders could liquidate if they became dissatisfied with the riskiness of a bank. Banks would have to be able to convince market participants that their investments would be rewarded. Those that could not do this would obviously not be able to expand.

In regard to deposit insurance, the U.S. Treasury

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Department has advocated risk-based premiums in its recent banking reform proposal. Such an approach would be a useful complement to the higher capital levels I favor. The Treasury's proposal to limit the number of insured accounts on an individual basis could also diminish the implicit subsidy now provided by the deposit insurance system. Along with reforms in deposit insurance and capital requirements, supervisory oversight should be capable of forcing institutions to take immediate steps, including liquidation when necessary, when their capital ratios fall below established thresholds. Once established, the regimen should be applied evenhandedly to all institutions regardless of size. No institution would be considered "too big to fail" because each would have a capital cushion that would help it make good on its obligations if it must be closed. Thus, the costs of the

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collapse and liquidation of the largest banks would be minimized. Once these reforms are in place, as I said earlier, I advocate repeal of the Glass-Steagall legislation of the 1930s that restricts commercial banks from engaging in investment banking activities. However, we could and should proceed with full geographic deregulation at once to move beyond the inefficient, patchwork system of state-legislated interstate banking that we now have.

Potential Effects of Industry Changes on Capital Formation

What effect would such efforts to reform the financial services industry have on capital formation in our economy and on the defense industry in particular? Some businesses have expressed concern that higher capital requirements, consolidation, and the like will make credit harder to come

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by. Indeed, there has been much talk of a "credit crunch" recently, and it is often implied that financial institutions have already reduced their lending in response to stricter supervision. I acknowledge that bankers and regulators alike are more wary--and properly so--of marginal credit arrangements. There were, I think, too many overly optimistic and even slipshod loans made in the past decade, and these have come back to haunt the industry. Thus, some tightening of standards was clearly appropriate. Still, I believe that truly creditworthy customers with viable projects are receiving and will continue to receive funding through their banks. Moreover, by bolstering the safety and soundness of the banking industry, the improvement in lending practices helps ensure that we can work through industry restructuring from a more solid foundation. What

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businesses need to keep in mind is that a strengthened U.S. banking system will encourage capital formation over the long term--as will a lower budget deficit that absorbs less of this nation's relatively meager pool of savings.

Some might say that because many large firms now go directly to the commercial paper market, the availability of bank credit matters only to small- and medium-sized firms and not to the large companies that typify the defense industry. However, banks play an important role in financial decisions among large firms as well. Recent research has suggested that equity market participants tend to bid up stock prices and thereby reward companies that use bank financing for capital expenditures, debt retirement, and other purposes. By contrast, private placements for the same activities tend

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to elicit no response from the market, while stock prices tend to fall when the funding method is a new issue of stock. The market's perception may be that ongoing relationships with customers gives banks an informational advantage in evaluating the riskiness of loans.

Moreover, when corporate managers work through a bank, where credit is usually extended on a short-term basis, they are subjected to relatively frequent reviews. Apparently, by accepting this discipline, companies give further evidence of their prudence. Restructuring the industry in ways that shore up its effectiveness would, I think, enhance banks' ability to provide this implicit credit-rating service. If lower capital formation costs are possible in this way, large corporations, along with their small- to medium-sized

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counterparts, have a stake in seeing a successful resolution to the current imbalances in the financial services industry.

Conclusion

In conclusion, the financial services and defense industries have had one foot each in the public sector and one in the private sector. They are shifting their weights, I believe, toward more market mechanisms. In the long run, the health of the nation's economy and of these two industries themselves can benefit from their transitions. If reducing their dependence on government helps lower the federal budget deficit and potential taxpayer liabilities, we can turn more investment toward the improved productivity many U.S. industries need to become more competitive in a global market. Equally vital to our future is a financial system

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capable of providing the defense and other industries the support they need at home and abroad. We must act--and act quickly--to bring the banking industry and its regulatory structure up to standards appropriate for the 1990s and the twenty-first century.

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