

REFORMING THE U.S. BANKING SYSTEM
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Good morning! I am pleased and honored to appear once again before the Georgia Bankers Association. I have been asked to give you my perspective on two key elements of the Treasury's proposal for reforming the U.S. banking system--interstate banking and the impact of other reform proposals on monetary policy. I have strong views on both of those topics, and they are based on what I believe needs to be done to improve our financial system in the long run. Unfortunately, we Americans have a tendency to take a short-term view of important issues. In the public policy arena this view too often has led us to address our problems with measures that treat symptoms and leave the underlying causes to generate new problems in a few years. Given the keystone role that banking plays in our economy, I think it is particularly important that we react to the Treasury's proposal with a keen awareness of underlying causes and the linkages among solutions put forward.

As I see it, one of the fundamental conditions underlying current problems in the financial services industry is that we simply have too many banks relative to the number of sound loan prospects. The resulting loss of profitability is taking a toll on the industry--especially among the largest and smallest institutions. Overcapacity has a number of causes. However, the one that policymakers need to address first is the deposit insurance system. Narrowing the deposit insurance safety net is only one of four interrelated steps that I believe are necessary to improve the competitive position of U.S. banks. The second is to introduce more market discipline by

bolstering capital levels and reducing the role of government subsidies and regulation. The third is establishing a regime of prompt and predictable supervisory action to be taken when capital falls below stipulated levels. And, fourth, we need to give banks the option of diversifying into new products as well as different geographical locations. While I believe product deregulation is contingent upon the first three changes, I believe we could--and should--move quickly toward full interstate banking which, in this context, really means interstate branching.

Repairing the Deposit Insurance System

Before discussing in detail this last reform--as well as your other concern regarding the impact of various Treasury proposals on monetary policy--I would like to review these other legs of banking reform, starting with deposit insurance. As you know, deposit insurance was designed to protect the banking industry from systemic runs--on weak and sound banks alike. 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. Larger depositors as well as some other technically uninsured 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 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. Unlike the thrift industry, banking 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.

Of course, deposit insurance did not by itself create overcapacity in banking. The numerical problem is more a result of competition from nonbanks, combined with improvements in technology and other innovations that have increased banks' productivity. When banks found they were losing market share to the nonbanks offering higher rates to depositors, many attempted to increase their traditional emphasis on personal service by building a large number of offices. By the time deregulation allowed banks to offer market interest rates, advancing communications technology had reduced the importance of physical facilities. Thus, a large number of those additional offices became superfluous even while their costs lingered on as a drag on profits.

More recently, though, the tendency toward overcapacity has been exacerbated by deposit insurance. This subsidy attracted a large number of U.S.-based entrants to our already crowded banking system. Once they had entered, they discovered it was difficult to leave if profits proved meager. The unique position of banks in the financial and payments system means that a closing must be supervised. Since exit from the system takes so long, banks that might otherwise go out of business add to the excessive number of institutions. Moreover, overbanking

tends to drive margins below those consistent with long-term profitability. In this way, the insurance system is inadvertently helping to push more banking institutions toward difficulties.

Clearly, we want our future financial system to eliminate the ill effects of deposit insurance while preserving the insurance system's positive contributions. I do not believe that the cost of insuring individual accounts up to \$100,000 is too great for assuring banking stability and consumer confidence. However, restricting the number of insured accounts that can be held at a given institution, as the Treasury has proposed, is certainly worth considering. Most important is the need for policymakers to reduce the deposit insurance subsidy in ways that sharply lower the risks now posed to taxpayers. The kind of risk-based deposit insurance premiums that the Treasury Department has recommended is one way of doing this. However, I believe that we also need to instill in the industry a greater reliance on market discipline. Increased capital levels are the most important way of increasing the role of the marketplace while at the same time lessening the threat that problem institutions pose to the insurance fund.

Higher Capital and Prompt Intervention

Of course, policy has already begun to move in the direction of higher capital ratios by the agreement among international regulators to institute risk-based capital standards. 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 institutions that want to take on additional activities.

Higher capital levels would create a larger buffer between mistakes even the best bankers can make and their need to draw on the insurance fund. Higher capital requirements also move us in the direction of relying more on market discipline. Banks would have to be able to convince market participants that their investments would be rewarded, and those that could not do this would obviously not be able to expand. If greater emphasis on noninsured debt instruments were also instituted, it seems to me that the resulting market discipline would be sufficient to insulate the industry as well as taxpayers.

The corollary to higher capital is supervisory oversight that would require institutions and regulators to take immediate steps, including liquidation when necessary, when capital ratios fall below established thresholds. This is the third result I would like to see emerge from the Treasury's initiative. In fact, a more formal program of progressive action keyed to capital levels could be instituted quite readily using the risk-based standards now in effect, with thresholds ratcheted up as higher capital standards are set.

These two reforms could even lessen the need to apply the "too-big-to-fail" doctrine. It is an unfortunate but inescapable fact that some institutions are deemed to be too big to be allowed to fail because their collapse would pose a systemic risk. However, with higher capital requirements and mandatory closure, presumably every institution would have a capital cushion to make good on its obligations if it became necessary to close it. Thus, the costs of the collapse and liquidation of the largest banks would be minimized.

Expanded Product and Geographic Powers

After reducing the deposit insurance subsidy and bolstering banks' capital, I believe we should allow a general expansion of bank powers. I would include, for example, underwriting corporate debt and equity issues. In fact, the Fed has begun to allow well capitalized holding companies to engage in these activities on a case-by-case basis within the narrow limitations in present law. 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.

One other change that could enhance banks' competitiveness would be the institution of nationwide interstate banking. In effect, of course, we already have interstate banking. All but two states, Hawaii and Montana, have legislation that now allow for a greater or lesser degree of interstate banking. This state-mandated patchwork helps banks achieve some of the market diversification that they need, but it is clearly not the most efficient way of going about it. The bank holding company structure requires separately capitalized subsidiaries, and this anachronistic provision leads to redundant layers of management as well as boards of directors.

It is difficult to justify these additional costs in the name of states' rights in banking, particularly at a time when we need to find ways of bolstering bank profitability. I believe that the dual system of state and national banking charters should be preserved, but I think we can bring more rationality to the system and lower costs as well by going directly to nationwide interstate branching. If holding companies could convert their subsidiaries into branches, they

could move to consolidate their corporate and operational structures. This would be a relatively quick way toward reducing some of the overcapacity that plagues the industry and thereby enhance banking profitability.

I know that numerous bankers--especially in the small- to medium-sized range--are worried that liberalized interstate regulations would have a negative impact on their local markets. Frankly, though, I believe that most community banks, especially those outside of metropolitan areas, have already experienced whatever major changes interstate banking might be expected to bring. Superregionals from outside the Southeast and the money center banks do not appear to me to be overly enthusiastic about acquiring small Georgia banks. Most are probably not interested in being minor players in metropolitan markets. Moreover, even if they wanted to come in, it is not clear that additional out-of-state organizations would be any more effective as competitors than the major statewide Georgia firms. In this regard, limitations on intrastate branching, which have important implications for defining the markets of community bankers, would remain on the books under the Treasury proposal.

I might add that smaller banks should view interstate banking as one thread in an entire fabric of regulatory reform that also includes, as I have already mentioned, greater latitude in product powers as well. I envision the small bank of the future as being able to provide its long-time local market with new services like insurance, real estate, and stock brokerage. Such a full-service provider would be better able to withstand outside competitors. In addition, beyond the very smallest banks, community banks are among the best capitalized in the nation today. Thus,

they will not have to experience some of the profound balance-sheet adjustments my approach to industry restructuring would necessitate for many of their potential interstate rivals. All told, there are numerous reasons to proceed to nationwide interstate branching.

Potential Effects of Treasury Proposals on Monetary Policy

Let me conclude by discussing the potential effects of the Treasury's bill on monetary policy. As I see it, nothing in the four aspects of banking reform I have just discussed would change the way the Fed conducts monetary policy. Yet, even though the Treasury proposal is not directed at monetary policy, two of the proposal's features could have important monetary policy implications if enacted. One is the concept to recapitalize the Bank Insurance Fund by borrowing from the Federal Reserve. The second is the proposed reapportionment of regulatory authority between the Fed and the Treasury.

With regard to BIF recapitalization, let me begin by stating emphatically that the fund must have adequate resources to provide for contingencies as we make the transition to a fully restructured system. I believe that banks should contribute to rebuilding the fund, but I also recognize that the maximum contribution we can expect from banks is limited. Increases in deposit insurance premiums are subject to the law of diminishing returns. I am concerned about the impact that the potential costs of further premium increases could have on an already troubled industry. In addition, excessively high premiums are unfair to the many healthy, well run banks that have consistently paid premiums greater than the value they have received from deposit insurance.

To avoid such near-term burdens on the banking industry, I agree with Treasury that the best strategy for recapitalization is to take down loans and repay them with future premiums. What is troubling about the Treasury proposal is the concept that the Fed should be the source of those loans. It is important to remember that borrowing from either the Fed or the Treasury has precisely the same budgetary implications. And, in order to avoid monetary policy implications, the Fed would have to match any loans it might make with the sale of Treasury securities. So capital markets would be called upon to absorb additional securities whether loans to the BIF originated from the Federal Reserve or the Treasury.

I am most concerned that this approach might create the perception of change in a very fundamental part of our central bank's structure, to wit, its independence in the conduct of monetary policy. The proposal implies that the Fed should directly fund government activities, and this is something Congress has sought to limit since the beginning of the Federal Reserve System. Because of that philosophy, the Treasury must accept market discipline whenever it sells its debt. Thus, the way in which both the Fed and the Treasury operate through the open market strikes a crucial balance between monetary and fiscal policy. Historically, the only occasions on which that balance has been altered were during wartime, and I do not believe that the condition of the banking industry presents us with a crisis of that magnitude. Thus, I think it would be unwise to opt for BIF recapitalization through Federal Reserve loans.

A second, and probably more substantial problem for the conduct of monetary policy is embedded in the proposal to redraw the lines of regulatory oversight. The Treasury bill would

make the Fed the primary regulator of state-chartered banks and suggests a new federal agency to regulate nationally chartered banks and thrifts. State-chartered banks, of course, are significantly smaller on average than the national banks, and the removal of the Fed from the oversight of the largest institutions could raise difficulties for the Fed's other responsibilities in monetary policy and in the payments system as well. The Fed's success at monetary-policy-making derives in no small measure from synergies between bank supervision and the application of our macroeconomic tools. The information we receive from the examination process is a vital supplement to the data provided by financial markets and economic reports. In return, our desire to achieve macroeconomic stability reinforces our interest in maintaining a safe and sound banking system. Were we to lose that layer of perspective provided by our regulatory relationship with the big banks, I fear our ability to fashion monetary policy would become considerably more difficult.

In addition, the time of transactions in the payments system is becoming more compressed daily, even as the size of those transactions is amplified. These exchanges have also long since become international in nature, meaning their successful completion carries implications for both financial and foreign exchange markets. On the one hand, the failure of a large institution at any time could leave the System exposed with regard to significant outstanding balances. On the other, the international risk requires the coordination of the Fed and other central banks. Again, it is critical for the Fed to be intimately aware of any developing problem that could raise such dangers. Therefore, I think serious study of these issues is required before the regulatory map is redrawn in any way. There is one final shortcoming to the regulatory reform proposal. It

does not pertain to monetary policy, but it is fundamental. Namely, the proposal does not really achieve the basic goal of simplifying the industry's regulatory framework. Merely rearranging regulatory relationships offers banks little in the way of efficiency gains. Thus, any benefits the legislation would bring are, in my mind, clearly outweighed by its costs.

Conclusion

In conclusion, I think the Treasury proposal has brought us to a moment of great opportunity. We have the chance to make constructive changes that can assure U.S. banks a prominent place in the global financial services market. However, every opportunity carries costs as well. There are the immediate costs of BIF recapitalization and the longer term costs of boosting industry capital. We must also find ways to work through a reduction in banking overcapacity. Bankers, policymakers, and the public must accept these costs and avoid the even greater costs that could be associated with quick fixes and incomplete solutions. To me, it is vital that we use the Treasury proposal as a compass pointing toward a comprehensive restructuring of the banking industry. I believe we are now facing in the right direction; it is time for us to step forward and forge a banking system that will work for the 1990s and the twenty-first century.