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THE OUTLOOK FOR BANKING REFORM IN THE UNITED STATES

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For the C.D. Howe Institute
Toronto, Canada
September 25, 1991

Good afternoon! I am very pleased to be meeting with you here this afternoon at the C.D. Howe Institute to discuss the outlook for banking reform in the United States. Because your legislators and bankers are accustomed to reviewing your Bank Act every 10 years, you certainly have more practice at banking reform than we do--about 120 years more, if my knowledge of Canadian banking legislation is correct. Thus it may seem a bit ironic for me to be speaking on the broad subject of bank reform, which, though infrequent and novel in the States, could be considered to be "old hat" in Canada. Yet, we can all learn from one another's reforms, and, by paying heed to the issues each of us is dealing with, we may discover new ways of solving problems.

In the United States, we preceded you in setting up a central bank. However, in certain respects, such as allowing banks to operate nationwide, we are now trying to emulate the kind of financial system you have established. However, while I believe the U.S. financial services industry definitely needs basic reform, I hardly believe it is in the hopeless muddle that some observers claim. In my talk with you today, I would like to lay out some history of our banking system to describe how we got to where we are now. I will also discuss the regulatory framework that was created, what I see as necessary reforms, and what exactly has happened so far with our Banking Reform Act.

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History of U.S. Banking

Whereas Canada's banking industry is dominated by a few big banks, now known, I believe, as the Big Six, the United States still has thousands of institutions--ranging from small, community banks to money center banks. These include more than 12,000 banks, 2,500 savings and loans, and 14,000 credit unions. The sheer number of banks is, however, somewhat misleading. In fact, big banks dominate in terms of their share of assets, and this dominance has actually been growing. Still, there is more diversity in the structure of our financial services industry.

Our regulatory framework is also substantially different. Partially because of the federal nature of our government and partially because of our geographically large economy, we have developed a dual banking regulatory system, with both federal and state legislation. Even at the federal level, there are three regulatory agencies--the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. Thus, we have a rather complex regulatory structure. Some would even say an insane structure.

Concern over the safety and soundness of our banking system during the Great Depression of the 1930s shaped not only two of the major regulatory agencies, but also the principles of our legislative restrictions. In particular, it gave us the rationale for separation of banking and commerce--a principle that is also fundamental to your banking system. In the 70 years prior to 1933, banks had carried on investment banking activities in addition to deposit-taking and the extension of long-term and short-term credit. The Banking Act of 1864 had initiated a period of "free banking," which allowed banks whatever powers were deemed necessary to the business

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of banking. Upper Canada had earlier struck out along this path with its own Free Banking Act in 1850, but most Canadian bankers preferred to continue receiving a special bank charter. Thus, "free banking" never took hold in Canada as it did in the United States. Meanwhile, during the free banking period, because the U.S. banks had already had experience in long-term credit and in underwriting state and federal debt instruments, they naturally moved into purchasing and reselling new stock and bond issues.

Although there were the inevitable cases of fraud that occur in every industry, in general the mixture of banking and commerce during that period is seldom blamed for any disruptions in the U.S. banking system. Panics like the one in 1907 tended to result from lack of liquidity. In fact, one of the basic reasons for establishing the Federal Reserve System in 1913 was to help the economy through such times. Even the collapse of the commercial banking industry between 1929 and 1933 seems not to have been related to problems with either banks' investment banking or direct investments in securities. Rather, it arose from a crisis in consumer confidence stemming at first from failures in small, poorly capitalized agricultural banks unable to deal with declining commodity prices. Nevertheless, the stock market crash of 1929 and revelations of abuses by the securities affiliates of large banks, combined with the suspension of operations by some 20 percent of America's commercial banks, helped to create an atmosphere in which separating the two types of businesses seemed proper, and indeed even necessary, to legislators.

Regulatory Framework Established in the 1930s

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The Banking Acts of 1933 and 1935 settled the matter with two sweeping gestures--deposit insurance and industry segmentation along institutional, geographic, and product lines. Deposit insurance was intended to enhance the safety and soundness of the banking system by eliminating the danger of bank runs: depositors no longer needed to worry, since their funds were initially guaranteed up to $2,500 and eventually up to $100,000. These laws also aimed at making the financial sector safe by prohibiting banks from underwriting corporate equity issues or purchasing equity securities for their own portfolios. In return, however, banks were given cartel-like powers over other products, such as demand deposits, along with geographic limitations that also curtailed competition.

These two measures--deposit insurance and segmentation of banks from thrifts and other financial intermediaries--seemed to succeed in making the nation's financial system safe and sound, but their effectiveness was largely a function of the economic stability of the next three decades. When this environment began to change in the 1960s and moreso in the 1970s, as inflation and interest rates rose sharply, the structure proved to be counterproductive. At that time, higher interest rates created an incentive to bypass many regulations. Among the most successful at avoiding interest-rate, geographic, and product restrictions were nonbank competitors. For example, the development of money market mutual funds, which used computer technology to offer a market-interest, short-maturity account to consumers, circumvented interest-rate ceilings on deposits as well as the geographic restrictions on conventional banks. Years of segmentation actually tended to make banks structurally and psychologically uncompetitive and left them unable to respond to these competitive challenges.

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We have been reforming this system in significant ways, and sometimes merely tinkering with it, for more than a decade now. Just as your current Bank Act revision will allow the so-called four pillars of the financial services industry--banks, insurance companies, trust companies and securities firms--to move into one another's businesses, market forces and legislation have been driving us in the same direction. It is clear that in both the United States and Canada, institutional boundaries are blurring. It is not so simple to declare what a bank is anymore, particularly since nonbanks now offer many bank-like services--checkable deposits and credit cards, for example. Similarly, our geographic boundaries have been breached. Even before we had the regional pacts among states, banks were moving outside of their own states by establishing offices that only made loans and did not take in deposits. And, as these barriers were broken down, so, too, was product regulation being relaxed. The Federal Reserve and the Office of the Comptroller of the Currency have granted permission to well-capitalized banks to engage in certain securities abroad, for instance.

On the legislative side, lawmakers in Washington, D.C., also began to address industry problems with the Monetary Control Act of 1980 and the Banking Act of 1982, which together made the playing field shared by banks, thrifts, and nonbanks somewhat more level. Financial institutions could compete in offering interest-bearing checking accounts and long-term CDs, for example. All in all, de facto deregulation and legislated deregulation were moving along at their own pace--until we hit the savings and loan crisis in the late 1980s. At this point, the Administration and legislators decided it was time to take a more direct, head-on approach to financial industry reform, if only to reassure the American people that such a large burden would

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not fall on taxpayers shoulders again. The Treasury Department was charged with developing reforms for deposit insurance, but in February it issued a more sweeping proposal entitled, "Modernizing the Financial System." Since then, committees in both the House and Senate have proposed their own banking bills, which are being debated in Congress in order to settle on a compromise bill.

My Views on Bank Reforms

Before I turn to a discussion of exactly what the Treasury Department and the various senate and house committees have put forth, let me address the key elements of banking reform that I hope to see enacted. As I see it, the most basic reform ought to be directed toward deposit insurance. Although deposit insurance has helped to shield the industry from systemic bank runs and has provided security for small depositors, it has also contributed to what is perhaps the industry's most critical problem, namely, overcapacity. Deposit insurance has served as an implicit subsidy, making it attractive to open a bank in an already crowded banking system. As a result, the United States now has too many banking institutions vying for too few sound loan prospects, reducing profitability to unsustainably low levels. Ultimately, this situation could pose a risk to taxpayers as well.

To some extent, the marketplace has begun to solve the problem of overcapacity through consolidation. Indeed, recently, some of the larger banks in the nation have begun to merge to strengthen their balance sheets. As we proceed through the 1990s, more community and regional banks may find themselves in similar situations. However, the public sector must play a role

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in the solution to overcapacity, because it has inadvertently contributed to the problem--both through regulation that created protected markets and by deposit insurance. While I believe it is socially desirable to keep deposit insurance, it is equally important, in my opinion, to reduce the deposit insurance subsidy.

Over time, this goal should be accomplished in large part through increased capital levels--higher yet than those agreed to among international regulators. The reason to increase capital levels for all banks is to make it less likely that any of them will have to draw on the insurance fund, in part because of the greater cushion each institution would have. Moreover, higher capital ratios would place more responsibility for oversight on equity holders. I do not expect market discipline to carry the entire responsibility for financial system safety and soundness, of course. When banks begin to get into trouble, prompt resolution is essential. More specifically, regulators must be authorized to require institutions to take immediate steps, including liquidation when necessary, when capital ratios fall below established thresholds. These two reforms could even lessen the need to apply the "too-big-to-fail" doctrine, which has contributed to the overburdening of our insurance fund. In essence, a bigger capital cushion will serve as a reform of deposit insurance, because it should obviate the need for it.

After bolstering banks' capital and reducing the deposit insurance subsidy, I believe Congress should allow a general expansion of bank powers. In particular, sound banking institutions should be allowed to get into the securities, mutual funds, and insurance businesses. Finally, I believe we must proceed to nationwide interstate banking, which we have in everything

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but name now. These four reforms should help reduce overcapacity and increase banks' profitability--without consolidating the U.S. banking industry so drastically that it loses some valuable aspects of diversity, such as the role of community and regional banks.

Reforms in Congress and Chances of Passage

Let me turn to the actual proposals before Congress. Although deposit insurance was a major impetus of the Treasury proposal, it looks as if politics is having a hand in diluting a full-scale reform package. The Treasury Department initially recommended limiting deposit insurance coverage to two accounts, including one retirement account. Both the Senate and House bills, though, would leave the present coverage as it stands now--$100,000 coverage for multiple accounts held by individuals--and it seems as if limiting coverage is now a moot point. (Actually, in my view, this reform tactic did not go to the heart of the issue.) The other element of Treasury's proposal--establishing risk-based premiums for deposit insurance based on bank capitalization and a risk evaluation for all assets--is incorporated into several Congressional bills. I am told this proposal stands a good chance of becoming part of the new regulations. I hope it does pass, though in terms of implementation, we will need to be reasonable in developing a transition period.

Both measures call for another aspect of reform--reining in the "too big to fail" doctrine--by instructing regulators to use the least costly method of resolution. However, each also makes an exception for bank failures that might cause a risk to the whole system, which is something the Federal Reserve has reluctantly agreed is needed in the interests of macroeconomic stability.

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The Senate and House bills also call for full nationwide banking and ultimately for interstate branching for banks, so I see this as a near certainty. However, states will retain control over intrastate expansion, leaving in place the bank holding company structure. This is perhaps the most we can expect now in our federal system of government.

In the more sensitive area of allowing banks to be owned by commercial firms and to have their own securities, mutual fund, and insurance affiliates, there is more controversy. It looks as if the forces arguing against allowing commercial firms to own banks will win the day. On the securities and insurance affiliates topic, I wish legislators could learn a lesson from Canadian banks, where you have proved that allowing banks to own affiliates seems to have worked well. I understand that Canadian bankers are now fighting to win the same ability to sell insurance. In the United States, a recent proposal from one of the House committees has dealt a blow to affiliation by allowing it on the one hand, but setting up so many limitations on dealings between banks and brokers so as to make it less attractive for banks to enter the securities business. This issue is too close for me to call, but I would hope that legislators will find some way to allow sound banking institutions to diversify their activities and better serve their corporate customers by having a broader array of powers, including some securities and insurance activities.

One other area of current interest is what the proposals say about foreign banking. The Fed has recommended that any final bill include provisions for enhanced supervision of foreign banks. Recent developments such as the revelations about BCCI highlight the importance of

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measures to strengthen oversight of international banking activities.

Conclusion

In conclusion, I feel confident that we will indeed end up with a banking reform act, just as certainly as you know that your legislators will finally pass a Bank Act of 1990 revision. Whether U.S. legislation will incorporate all the reforms I think are necessary to make our financial system safer and sounder is much harder to predict. If, as is possible, it does not, the Fed will face a greater challenge in carrying out its mandate of fostering financial system safety and soundness. More fundamentally, the costs of no action or incomplete action on the part of Congress would fall on U.S. banks, businesses, and taxpayers. Given the importance of economic reform, I remain optimistic that U.S. lawmakers will seize this opportunity to lay the groundwork of a financial system that serves us for the 21st century.

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