FINAL

OUTLOOK FOR THE BANKING INDUSTRY IN THE 1990s
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I am pleased to have been invited to address this group, whose membership, I understand, is the third largest in the country. As a bank regulator, I am certainly aware of how much we depend on accountants to ensure that corporate financial conditions are reported accurately--and meaningfully. In fact, one of the topics of debate in the banking industry now is whether to continue to use traditional generally accepted accounting principles (GAAP) or to switch to market-value accounting. I will touch briefly on this issue later in my remarks.

My overall topic this evening is the outlook for the banking industry in the 1990s. As many of you may have surmised, these should continue to be difficult times for banks--and for their customers. However, I do see cause for optimism in the consolidation that is taking place. This trend is helping some banks to strengthen their balance sheets and to increase their capital levels. In discussing the condition of the banking industry, I would first like to outline how it got to where it is today and then discuss how the industry might respond in the short term to the economic environment and banking reform legislation. Finally, I would like to look at the long term and envision the future of the banking industry after the year 2000.

Banking in November 1991: Where We are Today

Part of what has brought the banking industry to this time of consolidation and loan write-offs has been overcapacity and, more recently, an excessive concentration of real estate loans in

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their portfolios. Let me first address why we have too much capacity in the banking industry. As I see it, the main reason has been 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 served as an implicit subsidy. This has made 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 very low levels. Eventually, 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, as I alluded to earlier, some of the larger banks in the nation have begun to merge to strengthen their balance sheets. During the 1990s, more community and regional banks may find themselves in similar situations. However, the public sector must play a role 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. Unfortunately, lawmakers seem unable to come to grips with this underlying defect in the banking industry, although the narrow bill under consideration in the House of Representatives would, to some extent, reduce the safety net for the industry.

Another problem area for banks has been making provisions for and writing off problem loans. Although banks have long been able to make profitable loans to the real estate industry, that same industry is now in turmoil. After having overbuilt in most parts of the nation, some

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developers cannot repay their loans in a timely manner or according to the terms of the original loan agreement. You need only observe the near-vacant office buildings in Atlanta and its suburbs to recognize that banks which financed these projects are being adversely affected. Nonetheless, this region looks much better compared to New England, which has extensive real estate problems. And the potential downside is not nearly as great as it is in California. It is true that we are still seeing the effects of over-investment in real estate assets, since many of these loans are just now going bad, even though the economic recovery, in my opinion, is under way. This situation means that some banks may eventually have to write off more bad loans. Nonetheless, the worst is probably behind us, even in real estate.

Current Banking Reform Legislation

In addition to overcapacity and loan reserve write-offs, the proposed banking reform legislation has been another concern for banks. Even those institutions that advocate major changes find it hard to do strategic planning in an environment of legislative uncertainty. Before the banking proposal from the Treasury Department met resistance in Congress, I had had higher hopes that some serious and fundamental financial industry reform would result. Although I did not think the legislative reform proposals were perfect, I am currently less sanguine about the prospects for legislation that would systematically address the problems the banking industry faces. Right now, Congress is recognizing only part of the problem--the need to curb risk-taking by banks. The narrow bill that could be passed focuses mainly on recapitalizing the Bank Insurance Fund, tightening regulations, and eliminating the "too big to fail" doctrine by limiting the scope of deposit insurance and by requiring prompt resolution when problems arise at banks.

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There is also, though, still some chance that legislators will include a measure to allow banks to expand by way of nationwide branching.

What lawmakers are not recognizing is the need to allow banks to compete with nonbanks. Those of us who would like to see banks become more competitive with other businesses that offer bank-like services had hoped that the legislation would grant new powers to banks. Specifically, we would like banks to have the chance to sell insurance, securities, and mutual funds, similar to the way businesses in those three industries have been able to offer bank services, such as checkable deposits. If we end up with only a narrow bill that does not include these new powers, as I now fear, I believe Congress will have made a mistake. Certainly, legislators will have to revisit the same issues that are not resolved in this session. The trouble is that new legislation would probably not be taken up until after the presidential election, which means at least a two-year wait for badly needed reform.

Banking in November 1992: Short-term changes

If Congress and the Administration are not able to agree on fundamental banking reform--and, of course, I am in no position to forecast what Congress will do--the banking industry will not change a great deal over the next two or three years. Without the bank reform legislation, banks can only continue to slowly push their way into areas like securities. In fact, regulators have already allowed some of the best-capitalized banks to move into securities underwriting on a limited basis.

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Not all will remain the same, however. If Congress does incorporate the nationwide branching measure into the bill it finally passes, we will see many more banks crossing state lines to set up branches. Even if Congress does not include this measure in the bill it passes, big banks will continue to expand into new territory. The difference is that, without legislation, the changes will happen more slowly and perhaps less rationally. One way or the other, these moves toward nationwide interstate banking will promote more competition, something that is always good for customers. But there is also a good side for bankers to be considered. As it stands now, the patchwork of regional agreements among states has added to the expense of establishing new offices. The bank holding company structure requires redundant layers of management as well as boards of directors. If banking institutions could simply convert their subsidiaries into branches, they could move to consolidate their corporate and operational structures. This approach would be a relatively quick way to reduce some costs and thereby enhance banking profitability.

Of course, the other salient feature in the banking landscape will be the continuing consolidation. We have just come through a period of intense merger activity with such high-profile banks as Manufacturers Hanover, Chemical, C&S, and NCNB. Now comes the time when these merged institutions must transform their "on-paper" cost savings to real cost savings. This will take a certain ruthlessness. If banks cannot meet their targets for lower costs and higher profits, then there may be a slowdown in the number of mergers. Merger activity also depends on the strength of the industry. As long as times are bad, banks are not likely to volunteer themselves for mergers. In this kind of atmosphere, while we will continue to see

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problem banks being forced to merge, strong banks will be able to wait for better deals. Overall, though, as bank stock prices and equity values go up, there should be another wave of mergers down the road.

Banking in the year 2000--Envisioning the Future

If this consolidation trend continues, we might ask where this will leave us in the year 2000. I do not believe for a moment that the industry will pare itself to the five or six major banks that typify other countries, such as Great Britain and Canada. That is because the United States is starting from a point of 12,000 banks, thanks in large part to the historical absence of nationwide branching. There will be fewer banks--in my view, by the year 2000, the industry might be at 8,000 to 9,000 banks. But as to how many banks we will ultimately have, that is harder to say, because the optimal size of the industry will be determined by market forces.

As I envision the future for banks, I can see that the industry will still be diverse, and that it will remain structured as a tiered system. Today, we have three tiers: money-center banks, super regionals, and community banks. Two schools of thought prevail as to what the future structure will be. Either these three tiers would remain or they would rearrange eventually into two tiers. In the three-tiered structure, one tier would consist of a handful of national banking organizations big enough to serve the needs of the largest banking customers, including those operating abroad. Most of these banks would also operate national or large regional branch systems. A second tier would consist of a large group of community and niche banks. These will continue to be necessary, because community banks are the main source of credit for small

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business, which many believe plays a bigger role in the United States than in other advanced economies. Between these two groups of banks would lie the third tier of large banks, most with multiregional franchises. Alternatively, as the second school of thought would have it, the industry will end up with only two tiers, because banks in the middle tier would be subjected to considerable pressure either to grow large or to be acquired.

Concurrently, banks will be competing with a growing number of nonbank providers. I would hope that by the year 2000, banks will have earned the right to get into securities, mutual funds, and the insurance business. These new powers will be absolutely necessary to allow banks to compete in the marketplace.

In addition, banks in the year 2000 and beyond will have to offer more services to attract companies that will be marketing globally. Corporate clients will continue to migrate to the most efficient banks and locations--whether they are U.S. banks or foreign banks. If regulations limit U.S. banks or their markets, then businesses will, in effect, look off-shore in order to find what they need in the way of financial services. However, if given a chance to compete on a roughly level playing field, then the record of innovation by U.S. banks suggests that they will continue to be major players in the international financial services market.

In the United States, banks have not been merely creative, they have also been strengthened by adversity, which should be an advantage when it comes time to venture farther out into the global economy. Canada's Big 6 banks and the banks of most European countries

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have virtual monopoly franchises. They have not really been tested by much competition. Could it be that these institutions are not quite at "fighting weight"? In a global economy, such banks are likely to go head-to-head against many other institutions, both smaller and larger, putting these banks to the kind of test U.S. banks have already been enduring. Therefore, while the U.S. banking system may appear to be weak now, it may also turn out that our experience with adversity has helped to toughen our banks.

However, before U.S. banks can enter the global marketplace, they must first be able to weather the stormy 1990s. To get to the year 2000, they can particularly use your help. At the beginning of my remarks, I mentioned that bankers and regulators are debating whether to move from GAAP towards more market-value accounting. This form of accounting has been proposed to help solve the banking crisis and to help shore up the bank insurance fund. I believe the industry could use your assistance in evaluating the potential of market-value accounting. At this point, the American Bankers Association is on record against market-value accounting, because the association feels it would be too difficult and costly to implement. After all, bank loans are rather special products, unlike securities, and there is a sizable cost to valuing them. On the other side, many people concerned with the health of the Bank Insurance Fund would like to see market-value accounting used to promote prompter closures of weak banks, thus saving the fund from peril. A more valid debate could take place if bankers had a better understanding of the costs and benefits of moving to a system of market-value accounting.

Conclusion

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In conclusion, these are difficult yet exciting times for the banking industry. Hard times in the real estate industry are causing short-term problems for the bottom lines of banks. Congress does not seem to be able to bring itself to pass legislation informed by a long-term perspective--reform that would modernize the regulatory framework of the financial services industry. Meanwhile, consolidation is trimming the number of banks.

Yet, the future holds out a promise of new opportunities. Banks will be able to service clients that are marketing globally. Banks will also most likely be able to sell securities, mutual funds, and insurance. And, they will have learned many lessons about competing in a less-protected environment.

Those banks that survive the difficulties of today will certainly be more ready to take on the world. They will have trimmed their weight through consolidation and trained their managers to think innovatively. I, for one, am looking forward to the next decade when I believe that U.S. banks will prove they can compete with the largest banks in the global arena.

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