

REGULATORY ISSUES IN BANKING AND SECURITIES MARKETS

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When he speaks about the New York Stock Exchange, Chairman Donaldson often explains that self-regulation in tandem with governmental regulation has been critical to preserving investors' confidence in the equities market. In the banking industry, these same forces have been at work, although overly restrictive regulations have hindered the banking industry in ways not experienced by other segments of the financial industry. Quite often, members of Congress have felt the need to pass detailed laws to which banks must conform. In many ways, these laws--which impose geographic limitations, product restrictions, and a substantial regulatory burden--have created a difficult atmosphere for banks that wish to compete on an even footing with nonbank financial intermediaries and with banks in other countries.

I believe that in order for the United States to keep up with the rest of the world--especially in light of what we hope will happen in the European Community and in North America with trade agreements--we must rethink the way banking issues are handled in this country. Let me briefly describe how the United States lags behind other nations in terms of liberalized banking laws, before proposing how best to go about changing the situation.

U.S. Lags Behind Other Nations on Banking Liberalization

First, no other advanced economy has such a complex system of restricting competition geographically. While many other countries allow banks to set up branches nationwide, U.S.

banks can expand outside of their home states only where there are reciprocal agreements and then only by acquiring an existing bank and operating it as a separate subsidiary. This form of expansion requires redundant levels of management, including multiple boards of directors. While this situation stemmed from our geographic size, technology has clearly made these restraints obsolete and costly.

Second, U. S. banks have more restrictions on the products they can offer, often limiting them mainly to deposit-taking and lending activities. Contrast this situation with that in Germany, where a universal banking system does not divide banks into commercial and investment banks, and banks can deal in securities. Other countries, too, including Japan, have long allowed banks broad powers--such as owning stock in companies--that are not allowed U.S. banks.

These differences have become more glaring recently because of the global integration of financial markets and the approach of EC '92 and North American Free Trade Agreement (NAFTA). Although the Maastricht agreement, which posits one central bank and one currency, may be facing some delay, the single European market is not. EC '92, which will be complete in three short months, will liberalize banking practices further with a home country versus host country rule. Under the EC system, banks will be able to expand across borders based on a single license granted by the home country regulators instead of having to seek approval from the host country. The result should be expanded and more efficient international banking in Europe.

Looking ahead to the probable signing of NAFTA, we must also recognize that banks in both Mexico and Canada have broader powers than U.S. banks do. For instance, Mexico switched to a universal banking model in 1990. In Canada, banks have been allowed to own securities subsidiaries since 1987, and, thanks to passage of a new bank act, Canadian banks may now also engage in insurance activities. If all three countries ratify NAFTA, we will soon be tied together more closely than before. This trade accord makes it all the more important that our banking laws be more congruent with those of Mexico and Canada.

Why Is Being Out of Sync a Problem?

Even if NAFTA were not to be ratified, though, clearly U.S. banking laws hamper the industry from competing fully in the global marketplace. One obvious example of this hindrance can be seen in terms of growth. Geographic and product restrictions are keeping U.S. banks smaller than their counterparts abroad. For example, U.S. banks no longer rank among the Top 10 in the world in terms of assets. Instead, six Japanese and four European banks now take the top rankings. While bigger is not necessarily better, whether in terms of profitability or innovativeness, it is undeniable that the geographic limitations and the need to form separate organizations not only keep U.S. banks smaller but also make it difficult for them to provide a full complement of financial services to customers. Take a small business located outside of a major metropolitan area that needs to hedge an export contract. This small business could do so more easily in Canada with its national banking system than it could in the United States. In addition, product restrictions prevent banks from diversifying. Thus, compared with banks in other nations, U.S. banks are less well positioned to serve the needs of U.S. businesses that

compete globally.

What Needs to Be Done

In my opinion, it will take some strong measures to remedy this situation. Although I do not want to comment about the current political situation, I do know what a new Congress must do. Four areas merit attention. First, the United States needs to move quickly to the acceptance of nationwide interstate banking. The present regulatory framework imposes unnecessary inefficiency on the industry in that it requires multiple boards of directors and other costly duplications. Nationwide interstate banking would also promote more competition, something that is always good for customers. Small and medium-sized businesses could benefit from such an arrangement, because they would be able to look for credit from banks outside of the local community. Increased competition should also encourage banks to offer more services.

Second, U.S. banks must be granted new powers to catch up with banks in other nations that are allowed to offer securities, mutual funds, and insurance. I am in favor of all of these new powers, although I also realize that banks must be adequately capitalized to handle such diversification. In reality, we are already on the path toward some of these new powers, as the Fed and the Comptroller of the Currency have allowed bank holding companies and national banks to offer full-service brokerage to customers since 1987. In fact, three weeks ago, the Fed revised its rules to make it easier for banks to apply to offer these services.

A third issue is the need for Congress to recognize that it cannot mandate sound banking

practices. The attempts to do this have generated a regulatory burden that has become onerous for both banks and their regulators. If we look at some major pieces of banking legislation--such as the Expedited Funds Availability Act and the Federal Deposit Insurance Corporation Improvement Act (FDICIA)--we can see that these laws are so detailed as to leave very little flexibility for either regulators or banks. In response to perceived social problems, Congress has put regulators too much in the position of making business decisions for banks, even to the point of stipulating the level of executive compensation, without allowing banks to achieve reasonable solutions to the problems on their own.

The fourth issue that should be addressed in any new banking law has to do with breaking down the division between banking and commerce. Although I realize that this barrier is down in other countries, I still need to be more thoroughly persuaded that such a change would work in the United States, since both our regulatory framework and the financial industry structure are different from those in other nations.

Now, of course, there is another aspect to getting legislation passed, and that has to do with the role the industry itself should play. Bankers must learn to do two things better if they truly want to see some changes in banking laws. In the first place, they must work together among themselves. Last year when Congress was debating the banking law proposed by the Treasury Department, executives from large, national banks and those from small, community banks had trouble developing a common agenda. Bankers must also cooperate with the securities industry and insurance industry if they hope to get any legislation through Congress. Looking

back to last year again, the insurance industry lobbied effectively to quash certain new powers for banks. Since compromise is the name of the game in writing legislation, bankers must show they know how to play it.

Conclusion

In conclusion, the banking industry in the United States is increasingly out of sync with the world. Geographic limitations and product restrictions have limited growth in the industry. They have also curtailed the kinds of services bankers can offer their customers, who are dealing more and more in a global economy rather than merely the U.S. economy. In contrast, the securities industry has been well ahead of the curve in this regard, as it has turned to automated trading systems to keep pace with the increased volume and scope of financial transactions. These systems not only serve to open markets geographically; they also are laying the groundwork for 24-hour trading in order to satisfy customers around the world.

With EC '92 bringing expanded international banking to Europe and the promise of NAFTA tying the United States closer to Canada and Mexico, we must rethink the way certain banking issues are handled. I have briefly outlined a number of changes this nation could make to bring the banking industry back into the global competition. Such changes will not only strengthen the industry but also put it back on the same level with banking industries in virtually every other advanced economy.