PUBLIC POLICY AGENDA FOR BANKING REFORM AS THE INDUSTRY PREPARES FOR THE 21ST CENTURY

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Since bankers as a group have been dealing with so many changes in the industry lately, perhaps a change in the topic of my speech will not come as too much of a shock. As I considered what might be the most important issues for banking reform, I realized that the time has come to move on from the list of items we all agree are important, such as interstate banking and product deregulation. Instead, it is time to address the more fundamental problem facing both bankers and regulators: Banking reform can no longer be only banking reform, it must be financial services and regulatory reform.

That change in thinking means it is no longer useful to discuss a laundry list of legislative goals that encourages Congress to keep tinkering with our present system. Bankers and regulators must focus their efforts instead on proposing a new model of regulatory reform that will take into account the real-world situation. Banks today no longer compete only with each other for business. Now they must compete with nonbanks that can offer many of the same services as banks. It is clear that consumers no longer make the distinction that Congress does. They sample and purchase products from banks and nonbanks alike without seeming to care what the institution is called.

As we all know, this blurring of the lines between banks and nonbanks is causing a major upheaval in the industry. I am concerned about the situation for two reasons: one involves fairness--I believe the playing field should be level; the other centers on safety and soundness--I believe all entities offering financial services should be subject to some regulatory oversight. The forces prompting this blurred distinction among financial intermediaries have been in place for a while, but there is presently a newer and more pressing force involved, namely high technology. Today, I would like to discuss how technology affects both banks and regulators and how it has created the need for a new approach to regulatory reform. Let me begin with the changes technology is bringing to the banking industry.

Technology as a Force for Increased Competition

In the 'good old days,' most banks faced little competition from nonbanks and limited competition from other banks, especially for retail and small business accounts. Insured depositories had a near monopoly on short-term accounts, and they faced limited competition for general purpose small business loans. Furthermore, entry restrictions limited the ability of new banks to enter most markets. Banks did not need to judge the risk and return with extreme care during this period because inadequate profits from one customer class could be covered by superior profits from another class.

Times have changed dramatically, and banks face increased competition on all fronts. In part this change reflects deregulation, but, to a far greater degree, it reflects improved technology. Advances in communications, data processing, and finance theory allow existing competitors to become more aggressive and new competitors to enter ever more traditional bank markets. Banks must be able to evaluate the profits from each customer class--and often each product--because there are fewer and fewer products that earn superior profits. As you well know, the deposit monopoly was severely eroded in the late 1970s and early 1980s by money market mutual funds. Moreover, a large fraction of the remaining advantages of deposit funding are currently being eroded as time deposits pour out of the banking system.

However, today I want to focus on changes on the asset side of the balance sheets of banks. Increased competition is being spurred by three major developments: (1) the rise of securitization, (2) increased competition from nonbanks and (3) the explosive growth of the derivatives market. These three forces separately and in combination with each other are causing a radical reshaping of the financial services environment.

Large banks have long, first-hand experience with the impact of securitization. The movement of large corporations from bank loans to debt securities issued in financial markets began in the 1960s and includes progressively more risky firms and smaller firms. However, securitization is not just an issue for big banks. An ever increasing number of loan products are being bundled together into securities and being sold in financial markets. The change began with home mortgages. The development of Fannie Mae and Freddie Mac meant those mortgage loans no longer needed to be held in the portfolio of the originator. As a consequence, depositories could expand their origination efforts without being concerned about liquidity limitations or excessive exposure to interest-rate risk. Further, the securitization of mortgages meant that nonbank originators could compete on even terms with local depositories. In turn, the increased competition made the mortgage market more efficient, lowering costs to borrowers and lowering returns to mortgage holders.

More recently, credit card receivables are being securitized, allowing holders of large credit card portfolios to obtain additional liquidity. Credit cards had been one of the most profitable products of many banks. However, the increased liquidity combined with the standardized techniques for evaluating credit card customers are allowing a number of nonbank firms to play a large role in the credit card market. Nonfinancial firms such as AT&T, GM, and Ford have recently made major moves into the credit card market, in some cases with the support of banks. The new entrants were drawn in part by the profitability of credit cards. However, they were also interested in using cross-marketing with credit cards to support their core businesses. To pick one example, GM does not have to earn an above-market rate of return on its credit card business to be a success. It will be a success if GM can earn a market rate of return while supporting its core business of selling automobiles.

The latest effort in securitization is small business loans. Small business lending is another area that is attracting increased attention from nonbank providers of financial services. I am not sure that securitization will be as successful with small business loans as it has been with other, more standardized loan products. However, to the degree that securitization of these loans succeed, we can expect to see the same things that occurred in other securitized markets: increased liquidity for loan sellers, an improvement in the ability of banks to manage their risks, increased competition among banks, and a substantial expansion of the role of nonbank providers in the securitized market.

At the same time that securitization is clouding the distinction between depository and non-depository financial institutions, derivatives are wiping out the distinctions between different types of financial markets. Derivatives--such as futures, options, and swaps--began as methods for market participants to hedge their interest rate, foreign exchange and commodity price risks. However, investors and borrowers quickly recognized that derivatives opened up new ways for them to manage their affairs. For example, derivatives allow investors to quickly and cheaply shift between exposure to changing interest rates and changing equity values. On the borrower side, borrowers can pick the cheapest maturity--and even currency--in which to issue their obligations. They can then use swaps to convert their payments to the maturity and currency of the borrowers' choice. One consequence of this overlapping of financial markets for financial intermediaries is that risks that used to be bundled together, such as the interest rate and default risk on long-term loans, can be unbundled and separate prices established for each risk. Intermediaries that understand how to unbundle the different risks and to price each separately are in a good position to separate the profitable from the unprofitable loans. Those who cannot decompose loan risks face a 'winner's curse' type of situation where the only time they can beat the competition is when they unknowingly charge too little for a bundle of risks.

Please do not misunderstand these comments about market developments as complaints. The increased efficiency of financial markets and institutions is good for our country. Our ability to improve our standard of living depends on improved efficiency in all areas, including financial services. However, increased efficiency poses a significant challenge to bank managers, and I must confess, to their regulators. How you manage the change will determine the winners and losers in the financial services industry. How we as a nation handle the regulatory aspects will determine to what extent we realize the potential benefits while avoiding the potential problems.

All this discussion of the effects of technology on the banking industry may sound inconsequential to those whose banks are healthy. After all, banks in general have been doing well over the past two years, thanks in no small part to lower rates resulting from an accommodative monetary policy of the central bank. Most banks have increased their loan loss reserves, earnings, and capital, while problem loans have been declining. In fact, big U.S. banks recaptured their status as the most profitable banks in the world in 1992. Such good results, however, rest on a fortunate combination of events that may not last or be repeated. Therefore, I would urge each banker to take stock of the future and to prepare for it.

That future, even for the smallest of community banks, will certainly include more competition from nonbanks in credit intermediation. To add to the list of troubles, depositors themselves are becoming much more knowledgeable about their investment options, which means that banks must become more competitive to retain their role as the preferred intermediary for savers. Bankers of the future, therefore, must do better at providing high quality, useful products. I am not saying that every bank should offer every investment vehicle, but wise bankers will figure out who their core customers are and what financial services those customers need and desire. Then they will try to provide those services if they can earn a reasonable, risk-adjusted rate of return.

What Does Technology Mean for Regulators?

Having discussed what high technology can mean for bankers, I would like to answer the next logical question: What does it mean for regulators? Generally speaking, regulators cannot regulate in a vacuum. If high technology has become the moving force in the financial services industry, then regulators must focus more broadly.

Because the Federal Reserve is concerned with the health of the economy as a whole, it has an interest in seeing that bank regulation does not impose unnecessary costs on banks and, in turn, on businesses and consumers. At the same time, the Fed must respond to whatever poses significant risk in the marketplace. From this point of view, the activity in the derivatives market that goes largely unregulated causes concern not only for us at the Fed but also for regulators at other agencies. No one--neither regulators nor bankers--wants to see an overzealous marketer create problems that could harm the financial system. However, I do not believe regulators can approach this new technology with old regulatory techniques. One problem is that the people who invent these new financial instruments can change them faster than legislators and regulators can think of new restrictions.

But there is a larger issue involved here. Financial innovation means that regulators must be more innovative, too. Our current modus operandi is to regulate by institution. As banks become more like underwriters and mutual funds more like banks, though, institutions can no longer be clearly defined as one type or another. So this paradigm of regulation has actually already lost merit. Another type of regulation that has been suggested is to regulate by function or activity. That is, the Fed might examine the banking functions of banks and securities firms and the Securities and Exchange Commission (SEC) might regulate their equities functions. The fly in the ointment, though, is that derivatives break down the traditional distinctions by unbundling financial transactions into their various risk components.

I do not have an answer right now to this quandary of how we can move past the current regulatory framework with its ad hoc focus on fixing specific symptoms and problems. But I do know that the industry and the regulators need a new model. In addition, whatever that new model turns out to be, it must address the whole financial system rather than only the banking system.

In looking toward the 21st century, I applaud the enhanced efficiency in credit allocation and risk diversification that technology can bring. The Fed has long advocated a regulatory framework that does not burden the public with unneeded costs in investment and borrowing. Of course, I also have concerns about safety and soundness. However, while I see these developments as cause for increased diligence, recent banking legislation puts too much focus on safety and soundness, ignoring the important aspect of efficiency. For instance, instead of enacting fundamental banking reforms, such as interstate banking and product deregulation that would have made credit allocation in the United States more efficient, Congress enacted FDICIA and FIRREA, which 'micromanage' regulators as well as banks in an effort to guarantee safety and soundness.

The complexity and quick pace of the financial industry mean more than ever that it is time to turn from the old or, even more troublesome, the new way of regulating. Yes, this nation will likely never suffer through another S&L debacle thanks to new regulation, but is that really the problem of the future? I do not think so. In a high tech world, only a new model of regulatory reform can hope to keep up with the changes in products in the markets. The important thing ultimately is to limit systemic risk from these products. Early experimentation at limited volumes between banks and other responsible parties is fine for now. But as the volume scales up, regulators need to fully understand how the financial instruments work in order to put safeguards in place. Compared with those whom they are regulating, the regulatory agencies will be appropriately slow and deliberate. Although this state of affairs may suit some who use these financial instruments, I doubt that those who care about the safety of our financial system would like to see things remain the same as they are now.

Conclusion

In conclusion, the new forces put in place by technology mean that all banks--be they money center banks on Wall Street or small, community banks on Main Street--must be ready to play the new financial instruments game. At the same time, banks and nonbanks must be able to compete fairly. As it stands now, banks are at a disadvantage in that they do not have as much freedom of movement as nonbanks. However, everyone involved in the financial services industry must also recognize that it is time to invent a new model of regulation that is as innovative as the industry it is meant to regulate. Banking reform is simply not enough now that banks are no longer the only credit intermediaries. What is called for is new regulatory reform of the whole financial services industry. Only in this way can bankers and regulators alike reach the goal of providing for a financial system that is both efficient and safe.