THE FEDERAL RESERVE'S PERSPECTIVE ON REGULATORY ISSUES
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It is a pleasure to be here this afternoon to talk about the regulatory perspective of the Federal Reserve. The last time I addressed a banking group in Alabama, I was very concerned about a proposal that would have sharply limited the role of the Federal Reserve in bank supervision and regulation. That proposal did not win the necessary support, and today I am happy that the Federal Reserve still has a strong regulatory role and thus an official perspective on the subject. I plan to talk about three issues today: I will begin by speaking about credit quality, then move on to interstate banking, and finally discuss potential reform of the Glass-Steagall Act.

Credit Quality in Today's Banking Environment

Let me say first that, historically, banks in Alabama have had a very good record on credit quality. Moreover, the economy has been in very good shape in the last year or so. But please understand, as a regulator, the best time for me to warn you about maintaining your high standards of credit quality is when economic conditions are relatively strong, as they are now. The reason is that at such times bankers tend to become more amenable to making the kind of loans that go bad when the economy weakens. [I see that Terry Smith, our "top cop" at the Atlanta Fed, who will be on a panel this afternoon, is shaking his head in agreement.] That said, let me be clear that even though responses to our Senior Loan Officer Opinion Survey indicate some loosening of credit standards, I do not believe that credit standards generally have become inadequate.

I would like to make another point about credit quality: While banks have become much more adept at evaluating and grading risk, they still have to make progress on pricing that risk appropriately for different customers. If banks continue to charge a single interest rate for credit, then inevitably some borrowers who are not so risky will be overcharged while others who are riskier will be undercharged. My point is that if banks do not price the risks appropriately, then other financial concerns that are capable of doing so may pick off the best and most credit-worthy clients.

I certainly recognize that, in general, Alabama bankers do not need to be lectured on the topic of credit quality. At the same time, I am concerned that most of the banking industry does not appreciate just how big a difference the regulatory changes embodied in the Financial Deposit Insurance Corporation Improvement Act (FDICIA) will make the next time economic conditions weaken. The fact is that regulators do not have the leeway to nurse stumbling banks back to health since FDICIA became law. In the past, regulators had the ability to give banks every chance to recover before actually closing them down.

Under FDICIA, all that has changed. If a bank suffers losses that substantially weaken capital, then it will quickly come under regulatory and market pressure. The regulatory pressure is based on prompt corrective action that will generally end in closure when capital hits 2 percent of assets. Furthermore, implementation of the least costly method of resolution, as mandated by FDICIA, means that deposits over $100,000 are at substantial risk and are more likely to run from weak banks. The new reality is that, if you get into any trouble, the ability of regulators to give you a chance to work out of trouble has been sharply reduced. These new circumstances make it even more important to maintain your historic record of controlling credit quality.

Before leaving this topic, let me hasten to point out that not all the results from FDICIA are negative. The good news is that losses to the FDIC have been reduced, and that reduction means lower premiums for banks in the long run.

The Effects of Interstate Banking

Now let me turn to interstate banking, a new law that may not seem to figure heavily in Alabama banking, particularly since, up to now, the movement has mostly been for Alabama banks to go out of state rather than to see national or super-regional banks coming into the state. But it is interesting to note that matters may not go on forever this way. In fact, I would like to point out that, based on deposits, some Alabama-based banks are among the Top Ten banks in Florida. That alone should make some Alabama banks attractive to outsiders. So I think that, although you have not yet been affected drastically by the passage last year of interstate banking legislation, your time will probably come.

The eventual impact of interstate banking will depend in part on what each state chooses to do about the new law. For example, the Georgia legislature recently decided to keep in place the stricture that banks wanting to expand intrastate must still acquire a bank to do so. This legislation will somewhat reduce the benefits of interstate banking, especially for smaller banking organizations that border on Georgia and for whom it may be too expensive to follow a natural customer base into Georgia.

In the meanwhile, we are already beginning to see the effects of this legislation at the Federal Reserve. Our market share of check clearing is down, and the changes brought on by interstate banking undoubtedly have contributed to this decline in market share. In addition, because the banking system has the potential now to become much better coordinated across the nation, the 12 Federal Reserve Banks have been reworking the way we do business. Traditionally, the Reserve Banks have operated in a decentralized fashion, a pattern that in my opinion has contributed a great deal of innovation, flexibility, and responsiveness to customer needs. As the System moves to greater coordination and centralization, we need to strive to maintain these traditional attributes while providing a more consistent face to the growing number of customers that will be operating in multiple districts.

Reform of the Glass-Steagall Act

I have saved the most current topic for last--the recent efforts to reform the financial industry through repeal of the 1933 Glass-Steagall Act, which created the separation between commercial and investment banking. These initiatives by legislators and the Administration vary significantly, but all would open up securities activity completely. A bill sponsored by Representative Jim Leach, who chairs the House Banking Committee, and a proposal by the Administration--not as yet set forth in a formal bill--would also permit bank holding companies to engage in other financial activities, including insurance to a certain degree. Senator Alfonse D'Amato, who chairs the Senate Banking Committee, takes the further step of proposing that the current separation of banking and commerce be eliminated completely. His bill would allow bank holding companies to engage in financial, securities, and commercial activity. After years during which Congressional leaders were either tepid about or downright hostile to the idea of modernizing the laws that apply to the financial industry, these proposals come as a breath of fresh air.

But too much fresh air can create a wind that knocks down everything in its path rather than simply the barriers that prevent competition in our financial system. In this regard, I would like to explain my views on repeal of Glass-Steagall. Fundamentally, I think banks should be able to compete with other financial institutions. I do not believe, however, that banks and commercial or industrial firms should be allowed to affiliate at this time. Although we cannot draw a sharp dividing line between banking and commerce, I believe it is better to take these new powers one step at a time, starting with expansion into the financial side. My central concern in not wanting to pursue a broader version of reform is the possible effect it would have on expanding the safety net that now exists for the banking industry. On the whole, however, I favor further product deregulation in banking.

The main reason for favoring some new powers for banks is that modern global financial markets have created a situation in which financial organizations must be able to operate over a wider range of activities in order to compete. The rapid growth of computers and telecommunications--most often subsumed under the broad rubric of "technology"--has also contributed to a new environment that creates more competition by lowering the cost of financial services while also broadening their scope. Technology has enabled financial service companies to develop new products that have challenged the institutional and market boundaries that seemed so clearly demarcated until recent times. Technological innovation has also accelerated financial globalization, leading to an increase in asset holdings, trading, and credit flows across national borders. To take advantage of these increased flows, both securities firms and U.S. and foreign banks have increased their international locations. In doing so, they have been allowed to meet the competitive pressures of the foreign markets in which they operate by being granted powers--through subsidiaries--that are not permitted to them in the United States, such as global securities underwriting and dealing. Incidentally, U.S. banking organizations have been among the world leaders in such securities activities, even though their authority to distribute securities in the United States is limited under current law.

Besides these technological changes on the global level, here in the United States the states themselves have allowed expanded activities for state-chartered banks, much as states led the way in interstate branching developments. According to the Conference of State Bank Supervisors, in 1993 some 17 states had authorized banks to engage in securities underwriting and dealing. [The CSBS does not have 1994 data available yet.]

In the face of such technological change, financial globalization, and regulatory erosion, it is high time to remove outdated restrictions on well-capitalized and well-managed banks and to rationalize our system for delivering financial services. As matters stand now, the United States is behind the rest of the industrial world. Nearly all the other G-10 nations have already adjusted their statutes to permit banking organizations to affiliate with securities firms and with insurance and other financial entities. Of course, since 1987, U.S. banks have been able to get into securities underwriting by creating so-called Section 20 subsidiaries. These entities may handle a combination of eligible securities--ones not limited by Glass-Steagall--and ineligible securities, such as corporate bonds, but only 10 percent of the total revenues of the subsidiary may come from ineligible activities. This situation is an improvement over the pre-1987 situation for the largest commercial banks that want to get into investment banking and already have substantial financial market activities they can transfer to the Section 20 subsidiary. It does little, however, to help regional banks that do not have a sufficient base of eligible securities business revenue.

I also believe that banks are well situated to provide underwriting and other financial services to investors, not least because they understand the institutional structure of the market and are skilled at evaluating risk. Moreover, banks have built on their special ability to accumulate credit information specific to the borrower, as opposed to other kinds of lenders and investors that focus on more uniform or generalized information regarding stock or bond issues. Since banks understand their customers on the credit side in a more individualized way, it would make sense for banks to be able to handle the entire range of financing needs for a business. It seems to me that a business would appreciate being able to get all the financial services it needs from one organization, since it takes considerable time and effort to give an outsider an accurate picture of its financial situation. If the repeal of Glass-Steagall were to allow companies to rely on a single organization for loans, strategic advice, the underwriting of debt and equity securities, and other financial services, I believe firms would be more likely to expand their business with commercial banks.

As proposed by Representative Leach, these new financial entities would operate under the current holding company framework. I think this framework is important in order to limit the direct risk of securities activities to banks and the safety net. The holding company structure should also be the best way to keep from transferring to nonbank affiliates the subsidy implicit in the federal safety net--deposit insurance, the discount window, and access to Fedwire. The trick is to retain reasonable firewalls and other prudential limitations to protect banks from any risk from wider financial activities. Doing so in a financial services company that incorporated commercial firms would pose a serious challenge. Personally, I would like to gain some experience with other financial products before bringing this step into the public policy debate.

As for supervision of banks with newly expanded powers, I believe that it is important to have an umbrella supervisor, even though, as outlined in all the proposals, each unit would be supervised by function. To be sure, there is a danger that if the Federal Reserve or some other supervisor oversees the whole entity, then the market might come to believe that ultimately the government is as responsible for the wider range of financial services activities as it is for banks. Nonetheless, I know from experience that one regulatory authority should have an overview of the risks in the organization as a whole to provide perspective on the risks to the banking entity.

In general, then, I believe that the time is past due to modernize our financial system by widening the latitude for affiliation between banks and other financial service providers. The Federal Reserve has put its support behind the bill proposed by Representative Leach because it comes closest to giving new powers to banks while still maintaining the necessary degrees of safety to prevent systemic risk.

Conclusion

In conclusion, I have spoken today about a number of regulatory issues that either have changed or will change the way bankers now conduct their business. Many of these changes are exciting because they open up new opportunities for business for banks. Some of these changes are also difficult because they create more competition that calls for restructuring or new thinking about how best to serve your customers. At the very least, we can be thankful that in a dynamic financial world, Congress is finally talking about changing the ground rules that applied in more static times. I wish every banker here luck in coping with further changes, and I assure you that the Fed is addressing many similar challenges that arise from the changes in our financial system.