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Safety-net Issues in the New Financial Environment

Good afternoon. Before I introduce the moderator for the grand finale of the conference, I'd like to take a few minutes to briefly summarize some of the discussion over the past couple of days. First, though, I'd like to say that this has been another outstanding conference so far. I'd like to thank everyone who was involved in organizing this conference. Many people were involved and time doesn't permit me to mention everyone's name, but I do want to specifically mention two people: our Director of Research Curt Hunter and our Conference Chair Doug Evanoff.

Some 36 years ago, a group of approximately 20 economists gathered at the first Bank Structure Conference to discuss recent regulatory changes expected to have significant policy implications for the banking industry. Given the recent passage of the Bank Merger Act, the policy debate focused on bank mergers, antitrust considerations, potential efficiency gains and resulting gains for the consumer. The similarities with this year's conference are quite remarkable.

When we selected this year's theme last summer, it was in response to legislative and regulatory changes that had allowed for broader consolidation within the banking industry. Additionally, the theme was chosen because we believed that removing restrictions on cross-industry consolidation within the financial sector was long overdue. Having learned of our conference theme, Congress responded last November and passed the Gramm-Leach-Bliley Act.

As Chairman Greenspan said yesterday, the Act is expected to have a significant impact on the future structure and effectiveness of the industry. Over these past days we've discussed the effect of recent structural changes, and the potential for additional changes in the future. Clearly, conference participants generally agree that the financial environment is changing dramatically.

Yesterday we heard that environment described as “constant whitewater” with technology acting as the major driving force. This raises a number of challenges for the industry as customer needs change and the distinction between financial service providers disappears. It was argued that a critical competency in this new environment will be market segmentation. It’s extremely difficult to be all things to all people; and customers have absolutely no reservations in utilizing multiple service providers. The most successful financial firms of the future, it was argued, will be those that best utilize information technology to carve out well-defined market niches, while maintaining the cornerstone of successful banking: consumer accommodation and privacy.

Another speaker yesterday morning stressed that while the rules of the marketplace are changing somewhat, the fundamental force determining the success of firms will be the same as it has been in the past: management expertise. Firms striving to achieve size as an objective in and of itself, will find that size alone is inadequate. There are no substitutes for good management with a thorough knowledge of the demands of the customer base. However, there were also concerns about the potential abuse of market segmenting of low-income individuals and neighborhoods.

In the current changing environment, funding sources extend well beyond depository institutions. As a result, it was argued, fair lending regulation directed only at depository institutions will lead to a gradual shrinkage in the scope of such regulations, affecting, most importantly, the Community Reinvestment Act. This will lead, it was argued, to decreased competition for servicing lower income groups and a proliferation of predatory mortgage lenders and payday loan stores.

We also heard about new and evolving financial delivery systems. Vice Chairman Ferguson discussed his view of the central bank’s role in the market’s movement toward electronic payment mechanisms. He emphasized the symbiotic relationship between the private and public sectors. The private sector’s role is to innovate and develop new delivery systems. The public sector needs to ensure that there is an appropriate infrastructure for innovation and that any impediments are addressed.

One of the more exciting advances in financial delivery systems involves Internet banking. The potential upside in this area would, on the surface, appear almost unlimited. Yet we’ve seen relatively few firms succeed in this market. There are also regulatory concerns, and consumer fears, about privacy and security issues. It was argued that addressing these issues would go a long way toward establishing Internet banking as a viable medium.

The conference also focused on the impact of recent and future merger activity and the forces driving it. Yesterday Justice Department staff emphasized that the procedures for evaluating bank mergers will be similar to what has occurred in the past. While cross-industry mergers may involve a somewhat different process, these “product extension” mergers were not seen as potential antitrust problems. Empirical work presented this morning suggested that mergers have a disparate impact on different types of consumer loans. They may lead to scale economies in originating new automobile loans, for example, but greater market power for unsecured personal loans. Since bank services are not affected uniformly by consolidation, public policy must weigh the social gains and losses of this activity.

Much of the discussion regarding consolidation in the past has centered on the motivations for ‘buying’ banks and the resulting effects of those mergers on costs and profits. This morning we heard evidence regarding the motives for ‘selling’ a bank. The work showed that bank executives appear to weigh the positive effects of selling their banks on their own stock portfolios. It seems that there is much more to bank

merger analysis than simple comparisons of pre- and post-merger concentration ratios. We were also fortunate to have some of the leading authorities in the industry discuss the new capital requirements being proposed by the Basel Committee. It is well recognized that there are significant problems with the existing capital guidelines and that reform is needed. Indeed this morning the point was made that satisfying current capital requirements may more accurately be described as a compliance issue instead of a safety and soundness issue.

A major point emerging from the discussion on capital requirements was that capital adequacy is only one of many factors in evaluating a bank. The proposed New Capital Accord is a comprehensive package with three major components: quantitative requirements, supervisory implementation of these requirements, and market discipline. A representative from the Basel Committee stressed that the latter two are at least as important as the quantitative requirement and may become more so over time. One panel member said that the future capital Accord may involve an "evolutionary process" in which banks are given options varying in degrees of sophistication. Local regulators could decide where on the spectrum of sophistication the banks would operate. All of the panel members on bank capital emphasized the important role of market discipline.

This morning we heard an example of how market discipline can be more fully incorporated into the capital requirement. It was argued that requiring banks to continually pass the test of the marketplace by issuing subordinated debt would be a more effective means of managing bank risk behavior. Indeed, during the recent comment period, the Basel Committee received a number of recommendations concerning the potential for increased reliance on market discipline through a subordinated debt requirement. The debate, however, is still under way as empirical evidence presented this morning suggested that implicit safety net guarantees may favor larger financial institutions giving them advantages over smaller institutions in capital markets.

Discussion of the safety net brings me to our final session. I'm very pleased to introduce the moderator of the session — Lester McKeever. Lester is managing partner of Washington, Pittman and McKeever here in Chicago, but more importantly from the Chicago Fed's point of view he serves on our board of directors. I can personally attest that Lester has provided outstanding leadership for the Chicago Fed during his service as a director and as chairman of our board. We greatly appreciate his willingness to be here today. Please join me in welcoming Lester McKeever.