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THE U.S. BANKING INDUSTRY: CHARTING A COURSE THROUGH TROUBLED WATERS

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Congratulations on the completion of another program at the Stonier Graduate School of Banking. I taught at Stonier for seven years, and it is good to be back. For over 50 years, the Stonier school has provided bankers with the skills necessary to excel in the industry. Fortunately for you, the training at Stonier is first-rate and builds and strengthens abilities that you will be able to draw on for many years. However, the changing nature of the banking industry produces some uncertainty and concern for you, as bank managers, and for me, as a bank supervisor.

This evening I will discuss the prospects for the banking industry. There is mounting evidence that the U.S. banking system is unable to keep pace not only with its unregulated, domestic competitors, but also with counterparts abroad. As competition intensifies and the financial seas become rougher, it is imperative that we make fundamental changes to our financial system. Specifically, the safety net and its attendant regulation must be reduced. Ideally, deposit insurance coverage should be reduced below current levels and the "too big to fail" doctrine should be abolished. With these reforms in place, banks can be free to choose the organizational structure and product mix that they believe will maximize the return to shareholders.

Currently before Congress are numerous legislative proposals to reform the U.S. financial services industry. Some of the proposals deal only with the symptoms of the industry's problems and ignore the underlying fundamentals. These proposals amount to nothing more than a reshuffling of the deck chairs on a sinking ship. Moreover, a proposal has surfaced that, if adopted, would impair the Federal Reserve's ability to carry out its central bank responsibilities. I am referring to a proposal by the Task Force on Regulatory Restructuring to curtail the Federal Reserve System's supervisory authority.

Regulation and Its Costs

At present, we are essentially following the approach adopted nearly 50 years ago, amid the financial fallout of the Great Depression: the goal of a safe and sound financial system has been entrusted largely to a regulatory process, rather than to private decisionmakers operating in free markets. Regulators have attempted to achieve a strong financial sector by controlling the activities of certain classes of financial intermediaries, most notably commercial banks. Numerous constraints on the discretion of bank management to undertake risky competitive actions were imposed mainly through acts of Congress. Controls on pricing, products, location, and balance-sheet composition were designed to prevent the failure of individual banks. Moreover, deposit liabilities were insured (up to a limit) to reduce the incentives for depositholders to withdraw their funds in the unlikely event that a failure occurred.

From the mid-1930s until 1980, the banking industry met the two objectives of a successful, modern-day financial industry -- stability and profitability. The regulators appeared to be doing their jobs well, since bank failures were few in number and not costly. However, the 1980s illuminated the weaknesses of a heavily regulated system in a rapidly changing and more competitive economic environment. The rapid pace of change in economic conditions and technology highlighted the inappropriateness of regulations drafted five decades earlier. From 1942 through 1980, only 198 banks failed in the United States. Stability deteriorated throughout the 1980s, and failures by the end of the decade totaled 200 banks *per year*. Profitability has also suffered. Commercial banks' loan charge-off ratios and non-performing loan ratios are at their highest levels since banks began using this method of accounting in 1948.

What have we learned from this experience of exclusive reliance on regulation? It should be obvious that using government regulation to achieve economic goals entails both substantial costs and a number of risks. One risk is that a regulatory system will not be as effective as desired, both when initially implemented and over time. Another risk is that regulation will have unintended, perverse effects.

The present system of bank regulation, which includes numerous constraints on the market mechanism, is inevitably costly. Some costs are highly visible and explicit: regulated institutions incur compliance costs, and regulators bear monitoring costs. Other costs are not so visible. For example, costs associated with restrictions on permissible activities can prevent economies of scale and scope from being realized, thereby raising the costs of regulated firms. Restrictions on activities, products, and location decrease the options available to consumers and artificially raise prices by limiting competition. Regulatory barriers to competition may have a further subtle effect on the costs of regulated firms. Protection from competition reduces the incentives of regulated firms to minimize current costs. It also reduces their desire to seek out and adopt innovations that could result in lower costs in the future. Ultimately, the nonregulated firms will become the dominant suppliers of financial services.

Addressing the Fundamentals

To restore stability and efficiency to the U.S. banking industry, reforms must be adopted that reintroduce the dynamics of the marketplace to the banking sector. Two reforms are key to the establishment of market forces -- limiting federal deposit insurance and eliminating the too-big-to-fail policy. As you may know, I have staunchly advocated the reform of deposit insurance and the too-big-to-fail doctrine for some time. Let me briefly summarize the arguments supporting my position.

Deposit Insurance: The deposit insurance subsidy and the attendant system of bank regulation protect weak and inefficient depository institutions at the expense of their well-capitalized siblings. The direct costs of the present system have risen rapidly and, in all likelihood, will continue to do so. Deposit insurance premiums that used to average 4 to 5 basis points per dollar of domestic deposits in the early 1980s will rise to 23 basis points this year, and could increase further. Although there has been talk of capping the deposit insurance premium at 30 basis points per dollar of domestic deposits, Congress will always prefer to increase taxes on banks rather than to explicitly allocate general taxpayer monies to recapitalize the FDIC's Bank Insurance Fund (BIF).

As it is currently structured, the federal government's deposit guarantee program provides incentives for insured depository institutions to take on excessive risks. The fixed-rate premium penalizes safe banks and rewards risky ones by subsidizing the cost of funds for risky institutions. Marginal banks and thrifts pay nearly the same rate for deposits as well-capitalized depository institutions because, except for large deposits in small banks, all deposits are equally insured and deposit insurance premiums are not based on risk.

Unlimited deposit insurance also means further government involvement in the business decisions of banks, an intrusion that ultimately reduces banks' efficiency, profitability, and ability to compete with unregulated financial services providers. The safety net has been, and will continue to be, used to justify treating banks as public utilities. Community Reinvestment Act guidelines, lifeline checking, and assorted other consumer-oriented measures are additional burdens that banks have been, or will be, asked to bear.

Too Big To Fail: Policymakers and bank regulators have relied on the specter of the risk of systemic failures in the financial system to justify the policy of too-big-to-fail. Regulators have argued that the failure of a large bank could result in a loss of confidence in the banking system as a whole and thereby could produce runs on solvent banks. You will recognize this explanation as a reference to the Great Depression, a period in which the actual losses to depositors from bank failures have been greatly exaggerated. Regulators have argued that the failure of a large bank will cause the collapse of a great number of small banks because of the interbank exposure that arises from normal efficiency-producing correspondent banking relationships. The final, and currently most cited, argument for continuing too-big-to-fail is payments system risk. Some fear that the default of a large bank on the Federal-Reserve-operated payments system could result in the failure of other large banks with payments system exposure to the bank that failed, and possibly in the collapse of the payments system itself.

Although the aforementioned arguments for too-big-to-fail have considerable political appeal, none of these arguments can be justified on economic grounds. For example, there is no reason that the failure of a large bank should cause depositors to run on solvent banks. Should such runs occur, they could be handled both through appropriate open-market operations to protect the economy's liquidity in general, and through use of the Federal Reserve's "lender of last resort" facility to lend directly to solvent banks. Moreover, if bank regulators adhere to strict closure rules for all banks, then depositor confidence should not be affected by the failure of a bank of any size.

The current high level of risk in the financial system, which is used to justify too-big-to-fail, is in a very real sense a consequence of too-big-to-fail and the expanding size of the federal safety net. The safety net has encouraged banks to take more risks, and the costs of bearing those risks have been transferred to the taxpayer. Nevertheless, there is little political support for reducing deposit insurance and eliminating too-big-to-fail. Therefore, it is likely that we will not see legislative action on these two crucial reforms.

Should the Regulatory Structure Be Changed?

Given this political reality, I am concerned with a recent proposal to reduce the Federal Reserve's supervisory and regulatory responsibilities. My concern stems from the fact that failure to limit deposit insurance and eliminate too-big-to-fail means that market discipline will not control risktaking and excessive risk will continue to build in our financial system. The Federal Reserve, because of its charge to promote stability in the financial system, will ultimately have to contain the risk or pick up the pieces of a financial breakdown. Yet, this proposal would take away one of the tools required to carry out that task.

The proposal under consideration by the Task Force on Regulatory Restructuring would limit the Federal Reserve's supervisory role to bank holding companies in which the lead depository institution exceeds $10 billion in assets. The Office of the Comptroller of the Currency and the Office of Thrift Supervision would be merged into one Federal Depository Regulatory Agency (FDRA). The FDRA would be the primary federal regulator of all national banks, all holding companies in which a national bank with assets under $10 billion is the dominant depository, all savings and loans, and all savings and loan holding companies. The FDIC would become the primary federal regulator of all state-chartered banks, all state-chartered savings banks, and their respective holding companies.

I am concerned with this proposal because responsibility for the supervision of a limited number of holding companies is not sufficient to carry out our crucial central bank responsibilities. Risks to the financial system are primarily associated with the activities of banks, not bank holding companies. The task force proposal fails to recognize this critical distinction.

A properly functioning central bank, in its capacity as lender of last resort, can prevent irrational bank runs from becoming systemic runs by providing liquidity to the financial system through open market operations or lending directly to solvent institutions at the discount window. The Federal Reserve is the only institution that has the ability to create liquidity for the financial system and the economy in times of financial stress. To carry out its lender of last resort function, it is imperative that the central bank be able to accurately evaluate collateral and assess the solvency of the banks to which it lends. Yet, the Federal Reserve's responsibility for those banks would be reduced under the task force proposal.

The second source of systemic risk is related to the effects of a bank failure on the payments system. Again, banks, not bank holding companies, are the conduit for payments in this country, and the Federal Reserve is charged with the responsibility for maintaining a safe and efficient payments system. The Fed provides receiver finality on Fedwire, effectively guaranteeing payments, and therefore, it must have first-hand knowledge about the banks operating on the Fedwire system. In addition, the Federal Reserve is responsible for coordinating among the world's central banks international payments system rules, as well as international bank capital and supervisory requirements.

Moreover, if the Fed is going to be given responsibility for determining which institutions are too big to fail, as has been proposed, it must have hands-on knowledge about the financial condition of banks. More important, this information allows the Federal Reserve to intervene early and head off potential bank failures.

This is not the first time concern has been raised about reducing the Fed's supervisory responsibilities. In 1983, in a paper presented to the Bush Task Force on Regulation of Financial Services, then Federal Reserve Chairman Paul Volcker said, "... the Federal Reserve as the nation's central bank must remain substantively involved in the regulation and supervision of the financial and banking system because those functions impinge upon its general responsibilities. These responsibilities are broader than those implied by any particular operational mode for monetary policy; they go back to the founding of the Federal Reserve as an institution for forestalling and for dealing with financial crises."

Separating Supervision and Insurance at the Federal Level

One change that I would recommend to the bank regulatory structure is to separate the supervisory and insurance functions. This is necessary to ensure prompt closure of insolvent institutions, to protect the insurance fund, and ultimately to protect the taxpayer. Separating these functions avoids conflicts of interest. For example, under the present system, the deposit insurer could adopt a policy of capital forbearance to cover up its own supervisory errors. As an insurer, the deposit insurance agency should have the strongest possible incentives to maintain the value of its insurance fund. I suggest that insurers not supervise, but that they have greater control over the terms and conditions under which they offer deposit insurance.

In addition to separating the insurance and supervisory responsibilities, the deposit insurance function could be used as a check on overly permissive supervision, and on regulatory forbearance policies. To achieve this purpose, the deposit insurer should have the right to immediately terminate insurance coverage for new deposits when it determines an institution is being operated in an unsafe and unsound manner, and it should have the ability to charge differential premiums to institutions based on risk, including regulator risk. The deposit insurer could even factor the loss experience associated with each regulator into its pricing decisions, thereby establishing a pseudo-market price for regulatory services.

The Future of Banking

What is the banking industry likely to look like over the next several years? If meaningful reform is undertaken, the industry will be even more competitive and will change more rapidly than today. Successful banking organizations will find ways of becoming even more flexible and responsive to customer demands while controlling costs. In short, successful firms will focus on maximizing returns to the shareholder. Poor management will be more swiftly removed -- by market forces, rather than by regulators. Failure is a necessary part of competition. But failures and reorganizations will not come in waves and at taxpayer expense, as they do now; instead, they will proceed in a continuous, weeding-out process. With appropriate reform, the net result will be that many of you will be managing strong banking companies in the financial services industry of tomorrow.

Barring any meaningful reform and given the current trends, what is likely to happen to the banking industry over the next several years? That is, how are bankers like you likely to react in an environment of limited opportunities and increasingly expensive deposit insurance? Consolidations are apt to continue as managers seek to maximize shareholder wealth by searching for efficiency and profitability. As competition for traditional banking services and for methods of funding stiffens, you will be forced to innovate around the regulatory system to stay alive. In reaction, policymakers and regulators will constantly play catch-up, closing the discovered loopholes. As a result, the survivors will be the banks that are the most innovative in turning aside the regulations.

The pace of this gamesmanship will be quickened by increasing regulatory taxes. For example, as deposit insurance premiums climb, banks have a greater incentive to fund themselves through non-taxed sources such as deposit-like notes and foreign deposits. Currently, several larger banks are issuing notes that are a general obligation, like a deposit, but are not insured by the FDIC. The notes are typically issued by large banks, thus institutional investors are unconcerned with deposit insurance coverage. Whether policymakers intend it or not, banking activity will necessarily move to opportunities outside the boundaries of regulation.

Conclusion

Continuing under the present regulatory environment, banks' share of the financial services market will continue to erode. Aided by continued technological advances in the information industry and consumers' increasing access to and acceptability of non-traditional sources of financial services, business will continue to slip away from the traditional banking industry. Waves of failures will continue to occur and risks will continue to be socialized, to the detriment of taxpayers.

Curtailing the Federal Reserve's supervisory and regulatory responsibilities, without reducing the safety net, exposes the financial system and the taxpayer to unnecessary risks. An efficient and stable financial system will require meaningful reforms to the safety net. With these reforms in place, we can give banks expanded powers to compete head-on with nonbanks and international competitors, and banks can remain viable players in this increasingly competitive industry. Without these reforms the Federal Reserve must maintain a central role in the supervision and regulation of banks to ensure the stability of our financial system.