REMARKS BY

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I am honored to have the opportunity to address the mid-winter meeting of the New York State Bankers Association. This is my first appearance before this gathering as president of the Federal Reserve Bank of New York, having spent the bulk of my career on the private side of banking. What I would like to do in my remarks this morning is to step back and explore with you from a public policy perspective how I view the financial services sector of the economy today and what I think the critical policy issues are going forward.

The condition of U.S. banks is as good today as it has been for some years. The excesses of the past decade have largely been addressed. Financial health has returned to most banking institutions. This is true whether one looks at capital positions, earnings, or asset quality. A few statistics illustrate my point:
• **Bank capital.** Through the first three quarters of 1993, U.S. banks added $26 billion of capital to their aggregate balance sheets. Roughly one-third of that was added by the money center banks. Tier 1 and Tier 2 capital ratios increased for all banks in the aggregate as well. In addition, the number of banks in the undercapitalized, significantly undercapitalized, and critically undercapitalized categories decreased from 141 at the end of 1992 to 58 at the end of the third quarter of 1993.

• **Earnings.** Net income for all banks through the first three quarters of 1993 amounted to $42 billion and, on an annualized basis, was fully 35 percent higher than 1992 earnings. For the money center banks, net income at $8.3 billion showed even stronger gains, rising by almost 74 percent over 1992 levels. Non-interest income for all banks also improved in 1993; for example, trading income was up by almost 50 percent at the money center banks. In fact, trading income has actually become a steady enough earnings source that it has added stability to overall earnings.
• **Asset quality.** Improvements in 1993 were especially strong for the money center banks, whose net charge-offs decreased by roughly 35 percent and whose ratios of past due assets to total assets dropped from 4.1 percent to 2.7 percent from year-end 1992 to the end of the third quarter of 1993.

The market rewarded these significant measures of improvement in the banking industry last year with broad-based increases in stock prices and upgrades in long-term debt ratings. These are all welcome developments.

At the same time, however, I must add a note of caution. While undeniably in better health than they have been in years, U.S. banks nonetheless remain in stiff competition from a wide range of other financial services firms, domestically as well as globally. The competition has taken place against a constantly shifting landscape for banks and nonbanks alike.

In the United States, as you well know, there has been considerable consolidation within the banking industry over the past decade. From some 15,000 commercial banks in the early 1980s, there were just under 11,500 banks by the middle of 1993. More significant has been the decline in the share of credit assets in the financial sector intermediated by commercial banks. This share has declined
steadily over the postwar period from just under 60 percent at the end of World War II to roughly 22 percent today.

In addition, U.S. banks have had to compete in an environment that has witnessed the restructuring of financial markets globally. In Europe, for example, the move toward a unified market has entailed substantial consolidation of the financial services sector into fewer, larger, and better capitalized institutions. Moreover, many of these institutions, because of differences in national regulations, are able to offer a broader array of products and services and compete in a wider variety of markets than U.S. banks are able to do.

Similar challenges face all providers of financial services in the U.S.—not just the banking industry. If we look at the financial industry as a whole, I believe we will agree on two major points.

First, the financial services industry today is segmented both in terms of its structure and its regulatory environment. This segmentation increasingly makes less sense as banks, securities firms, insurance companies, and other financial firms compete with one another in offering similar or related products to the same customers. Moreover, the regulation of the financial services industry is a patchwork of market and institutional regulation which reflects, not any carefully defined and forward-looking process, but rather a series of ad hoc responses to
historical developments, with no central theme. As such, the structure has become outmoded and badly in need of change.

Second, the fragmentation across industry sectors with which we currently live has had some worrisome effects on the competitiveness of our financial institutions. Fragmentation has detracted from the ability of our firms and our banks to compete on an equal basis both domestically and internationally. The international dimension, as I mentioned, is particularly evident. Fragmentation has also inhibited periodic efforts to achieve consistency in regulatory approaches on a wide variety of fronts, again domestically as well as internationally.

In considering an appropriate future path for financial market reform as well as modernization of the financial oversight function, I believe we must begin to shift our attention away from the provider of financial services and look instead at the entire financial services industry from the vantage point of the user or customer of financial services. In today's marketplace, all of us as customers of financial products are presented daily with a vast array of similar or substitutable services. In the search for attractive services at a fair price, we customers will naturally favor those firms and banks that
can respond to our needs quickly, effectively, and at the lowest cost.

Why do I find it so helpful to start my analysis with the needs of the user rather than the provider of financial services? There are essentially two main reasons, and they are relatively simple. First, I believe that the providers of financial services must be responsive to the needs of their customers. This is a basic tenet in any industry that hopes to be successful. Second, I believe that regulation, too, is ultimately self-defeating if it ignores the needs of the customer and thereby perpetuates the inefficient delivery of services.

In principle, I believe that public policy, especially in a democracy, should be based on the needs of the people as a whole. It gives the legislative and executive branches of all governments the right perspective: their obligations to all the people and not, pace the lobbying profession, to special interest groups.

You may well ask, who are these members of the public—these customers—I have in mind? Basically, I see two broad categories of customers, although I do appreciate that the boundaries between them are not sharply drawn. The first category encompasses the smaller, retail-oriented, comparatively less sophisticated customer. Such customers may be individuals, small businesses and institutions, relatively modest investors, and some small
government entities. The second category consists of the large, wholesale-oriented, more sophisticated customers. This category may include major institutions, larger government entities, securities issuers, market makers, and sizable investors.

Having identified who these customers are, we must next ask ourselves what kinds of services these customers want. Let me highlight some needs most customers typically seek or require:

1. Deposits or other transactions accounts to meet daily and ongoing needs;
2. Payment and settlement services to conduct business in a prompt and assured fashion;
3. Savings instruments for longer term needs;
4. Credit intermediation services, such as providing loans and guarantees;
5. Market-making and the taking and hedging of financial risk;
6. The provision of liquidity or the maturity transformation of assets;
7. Insurance services; and
8. Securities services, including underwriting, dealing, brokerage, and investment advice.

In our marketplace of today, the institutions providing some mix of these services run the gamut of
financial services firms. These firms range from domestic and foreign banks to securities and commodities firms, mutual funds, insurance companies, finance companies, advisory firms, and unregulated firms such as hedge funds and swap subsidiaries.

While these financial services firms may provide a number of overlapping products, the ways in which they deliver their services can be a key competitive element distinguishing one from another. For example, some customers value a provider's ability to combine many services into one package. For these customers, who might typically be individuals or small retail firms, one-stop shopping may be a priority. Other customers, by contrast, are willing to spend the time to pick and choose among providers for each service, seeking the best fit for each particular need. While these latter customers could also be individuals and small retail firms, they would tend to include the larger corporate and institutional firms.

This boundary between the retail and the wholesale customer, however, masks some realities of the marketplace. That marketplace is neither static nor immutable, but rather is dynamic and ever-changing, driven by the constantly evolving demands of its customers. It is usually the customers' expression of their demands that provides impetus to the changes that occur in the marketplace.
The ways in which financial services firms respond to the changing demands of their customers are shaped in major part by changes in technology affecting the feasibility and the relative costs of providing the services desired. The technological advances of the past decade have made it possible to offer customers increasingly more convenient as well as sophisticated products at substantially lower costs. Automated teller machines and tailor-made hedging instruments are only two examples of such advances.

But it is not just technology that governs how financial services firms respond to the changing demands of customers. The reaction of these firms to the needs of their customers is also conditioned by the regulatory environment. All too often, regulation is not friendly to change. For example, when regulation protects the regulated entity from competition, it means that the customer is very unlikely to get the right services in the most efficient and least costly manner.

This issue of regulation is important. It is clear to me that many regulatory initiatives made sense in their day, although it is also fair to say that the resulting regime, designed largely in the 1930s, even then had an important element of deliberate overkill in it. In concentrating on protecting the customer, it inhibited the provision of new and cheaper services. The technologically
sophisticated world in which we live today, however, together with the immediacy of financial market competition worldwide, has left the regulatory regime in our country badly in need of overhaul.

The tangible as well as the intangible costs of living under an outmoded regulatory regime can be considerable—whether in raising the price of financial services or in thwarting the delivery of these services by some, if not all, providers. Given the available choice of financial services firms in the current environment, customers can simply pick up and move to the next provider, domestic or foreign, which may operate under fewer regulatory constraints, or perhaps none at all, even in cases where regulation seems to be indicated.

As I take stock of the financial services industry today, I have begun to ask myself whether this may not be the ideal time for us to consider together alternative ways to satisfy the needs of users of financial services—both through actions by the banking industry and through changes in the regulatory regime for financial services firms more broadly defined. In such an undertaking, it might even be necessary to take a fresh look at federal deposit insurance. After all, there may be ways to provide insurance to those customers who wish to have it without imposing high regulatory costs on those who choose to do without.
At the same time, it may also be worthwhile to rethink the current boundaries between providers of financial services. I refer here to the desirability of allowing different financial institutions to select the range of services they wish to provide, based on their comparative advantage. We might ask ourselves, for example, whether it is possible to allow some institutions to meet the needs of those customers who value one-stop shopping and allow other institutions to provide a narrower range of services targeted at other customers. Potentially, a firm could choose to provide anywhere from a full range of financial services to just one service.

I have no illusions about the difficulty of the issues I raise; nor, I want to make absolutely clear, do I profess to have all of the answers. Certainly, I do not have a blueprint. Rather, I am firmly convinced that, if we approach these issues from the point of view of the user rather than the provider of financial services, we can see that common issues confront the entire financial services industry.

I believe that these issues of commonality are far broader than the matter of which federal institution performs bank supervision. I cannot help but think that, when we consider the structure of banking supervision before considering the appropriate restructuring of the whole financial services industry, we are putting the cart
before the horse. This is simply not sound public policy. At the same time, I fully recognize that several proposals have already been put forward to restructure bank supervision alone, and we need to respond to these proposals. My views on this subject are well known by now, since I set them out in an op-ed piece in the New York Times. Let me simply reiterate how important I believe it is as a matter of public policy for the Federal Reserve to have hands-on involvement in bank supervision. In the absence of such a role, this nation's ability to forestall or respond efficiently and effectively to future financial crises would, as Chairman Greenspan has pointed out, surely be impaired. I would prefer to get the horse back in front of the cart and first address the restructuring and modernization of our financial services sector. If that is not possible, then I believe that the Federal Reserve Board's proposal offers a sound solution.

If, on the other hand, we are ready as a nation to take up the challenge of reassessing and rationalizing the legal and regulatory structure governing our financial services industry, I urge that we undertake a comprehensive review of the industry's current fragmented supervisory structure. Clearly, any effort to modernize the current legal and regulatory framework must, from a public policy point of view, meet a number of critical tests if it is to be responsive to the marketplace of today. In my view,
an appropriate framework must satisfy the following principles:

1. Encourage market discipline to the maximum extent possible, consistent with achieving a safe and sound system.
2. Promote greater responsiveness to changing customer needs and preserve market creativity.
3. Establish a level playing field for all institutions providing the same generic services, whether these institutions are called banks or something else.
4. Recognize the public interest in the safety and soundness of financial institutions through consolidated, comprehensive oversight of all providers of financial services.
5. Be receptive to change on the part of the industry and to the evolving nature of financial institutions.
6. Promote systemic stability, the ability to deal adequately with financial market problems, and the effective implementation of monetary policy.
7. Provide consumer protection where needed, making certain that the public interest and the needs of all individuals are addressed.
The principles embodied in this framework lead us to rethink very fundamentally how we oversee the activities of both financial markets and financial firms. It may well be that greater use of surveillance of markets and institutions could provide a fruitful way to begin to approach some of these issues. By surveillance, I refer to a form of oversight that allows market participants wide latitude in determining how to respond to evolving challenges, and at the same time ensures that wrong-doing is caught. The official overseers would vary with the market. There should not be a monolithic "Big Daddy" regulator.

Within this framework, market surveillance would allow market participants leeway to conduct business without unnecessary restrictions, but still be subject to scrutiny by supervisors. It would be incumbent on market participants to develop codes of conduct, guidelines of sound practices, and other elements of self-regulation for their activities. By this means, market incentives and forces would effectively serve as a first line of defense against those who abuse the market. Prompt and effective official intervention would be called for when market forces fail to address or contain problems. And such intervention should be very direct and very tough. Bad guys should be punished.
Firms demonstrating that they have the needed capital strength, internal controls, management information systems, and management experience would be subject to comparatively less oversight over the conduct of their activities than those lacking these strengths. Supervision of individual institutions would be required to ascertain which firms have these characteristics. This implies a continuing role for periodic on-site examinations by examiners expert in the specific services provided to assess whether institutions are financially strong and operate in a safe and sound manner. Examinations are also needed to test compliance with regulations, including fair and non-discriminatory dealings with retail customers and attention to the needs of the inner cities. The financial services industry cannot solve the problems of inner cities, but, especially as part of a sensible overall strategy, it can and must be part of the solution.

Let me make clear that institutional oversight need not be highly intrusive. But, as with market surveillance, it is necessary to have prompt and aggressive intervention when problems emerge. Most important, in my view, is that the framework in place be responsive to changes in the marketplace while simultaneously continuing to instill widespread confidence in the integrity and soundness of our financial markets and players.
Where would the Federal Reserve be likely to find itself in such a future? Let's apply the basic approach that we should be guided by our customers. Our customers are the American people to whom we provide the product of a sound monetary policy implemented through depository institutions. Depository institutions are the customers to which we provide those services which make up the core of the dollar payments system. To implement monetary policy and to provide the payments system, we must know our customers fully, just as you must know your customers. Part of knowing our customers will, without question, require hands-on supervision of depository institutions, both domestic and foreign, throughout the country.

The principles and thoughts I share with you this morning are only a beginning. Clearly, my thinking stems from concerns that have plagued us for some time now—and not for lack of efforts to address them. By calling on you to consider a framework that places the needs of the customer and not the provider of financial services at the starting point of our thinking, I have sought to find an alternative approach to the impasse we so often have found ourselves confronting. This shift in the focus of our debate may suggest opportunities for solutions that have eluded us thus far. It is the correct perspective from which the public policy debate should take place.
I am convinced that the broad contours of the issues I have placed before you would greatly benefit from your analysis and attention. I encourage you to look at the issues from the wider perspective, furthering your own interest as you do so. The banking industry, as market share statistics clearly show, has not benefited and will not benefit from the fragmented approach of the past and present. The public interest—as well as the interests of the financial services industry at large—is at stake. I believe that the customers of tomorrow merit our most thoughtful consideration today.

Thank you.