

**FEDERAL RESERVE BANK  
OF SAN FRANCISCO**

**OFFICE OF  
THE PRESIDENT**

**Maintaining Competitiveness in Global Financial Markets:  
Can the U.S. Keep Up?**

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Over the last ten years, the U.S. economy has become more closely linked to world markets. Gone are the days when we could ignore economic and financial developments outside our borders. Decisions made in markets in Tokyo, Hong Kong, London, and Milan, to name a few, have profound impacts on all of us.

The ties that bind the U.S. to the world economy are particularly strong here on the West Coast. In recent years, we've seen enormous growth in business between ourselves and the rest of the world -- most notably between ourselves and the nations of the Pacific. The value of international trade through Puget Sound ports, for example, quintupled between 1978 and 1988.

The internationalization of our economy now reaches into every corner of the West Coast -- from aircraft manufacturing here in Seattle to rice production in California and from fishing in Alaska to logging in Oregon.

One area where internationalization is particularly apparent is finance. Today, there are 190 foreign banks, branches, and agencies in the Twelfth Federal Reserve District. Ten years ago, the number was 133. In the early 1980s, foreign investors bought an average of around six percent, or \$10 billion, of the net U.S. Government securities issued each year. Foreigners' share of U.S. Government security issues generally rose through the middle part of this decade and by 1988, jumped to \$68 billion, or 23 percent of the net securities issued. And judging by the persistence of our large federal budget and trade deficits, and our still-low rate of private saving, foreign funds will continue to play a major role in our financial markets.

Some see this influx of foreign investment in securities, real estate, and manufacturing as a bad thing; an evil to be avoided or at least curtailed. This approach reminds me of the irony in a scene in Woody Allen's film, "Love and Death." A Russian commander tries to rally his troops to combat Napoleon's forces and the "menace" of French culture. He says, "Imagine your loved ones conquered by Napoleon and forced to live under French rule. Do you want them to eat that rich food and those heavy sauces? Do you want them to have souffle every meal and croissants?"

Frankly, I don't see the growing ties between the U.S. economy and world markets as something to be resisted. But I am concerned that U.S. firms be allowed to compete effectively. So, one question I'd like to put to all of you today is the following: Are we, through legislative and regulatory decisions, helping or handicapping a key industry -- that is, the financial services industry?

The answer to this question will help to determine whether the Twelfth Federal Reserve District, the West Coast, and yes, the State of Washington are equipped to play an important role in tomorrow's world economy.

My own answer is that, as a nation, we may be hamstringing the industry's ability to compete. In fact, I worry that one unfortunate consequence of the thrift crisis will be a trend toward more onerous restrictions on financial firms.

We should not allow this to happen. Moreover, there are several steps we could take to unshackle American firms. First, let's allow financial firms to hone their competitive edge here in the U.S. by dismantling domestic geographic barriers to expansion. Second, let's give our banking institutions the opportunity to compete more effectively by allowing them to expand their activities. Finally, let's avoid future crises in the financial services industry by reforming the deposit insurance system in this country. I want to take a few minutes to discuss each of these suggestions.

### Dismantling Geographic Barriers

Turning first to geographic barriers to competition, it's useful to consider the upcoming removal of such barriers in Europe and to compare that to the situation in the U.S. In 1992, European financial firms will be able to operate freely throughout that continent. In contrast, U.S. banks still will not be allowed to operate in every state in this country.

Moreover, European banks will have a domestic market of 325 million people. The domestic markets of U.S. banks will be limited to a patchwork of individual states, comprising significantly less than the total U.S. market of 240 million people.

Current banking law requires that individual states take the initiative to dismantle these geographic barriers. In the Twelfth Federal Reserve District, we've made good progress in this regard. Here in Washington, for example, banks headquartered anywhere in the country are allowed to enter on a reciprocal basis. And in 1991, California's borders will be open to banks from any state in the country, again, on a reciprocal basis. However, a number of states in the West and in the rest of the country still have very restrictive out-of-state entry laws. Clearly, more can and should be done to remove geographic barriers.

Dismantling these barriers not only would hone our competitive edge, but would enhance financial stability. The key word here is diversification. If banks in Alaska and, particularly, Texas had been allowed to diversify their operations into non-energy states, I seriously doubt we would have seen such high failure rates in those two states. Likewise, if farm belt banks had been allowed to diversify outside the Midwest, we probably wouldn't have seen so many closures there. In contrast, I believe that banking in Arizona will fare better than the state's weak real estate market might suggest since those banks are affiliated with banks in areas with currently stronger economies.

However, please don't get the impression that small, locally-oriented community banks won't play a significant role if we dismantle geographic barriers. A handful of Pacman-like superbanks is not going to gobble up the local competition. Rather, opening local markets to out-of-state competitors will encourage community banks to differentiate themselves. There will always be businesses and households that need -- and are willing to pay for -- the flexibility, superior knowledge of the local economy, and extra service that community banks can offer.

The State of Washington is in the vanguard in this respect. As you

know, the larger banks here are now affiliated with bank holding companies headquartered outside the State. Although this has raised concerns about "absentee ownership," it offers substantial benefits, as well. Let me suggest a few. First, affiliation with out-of-state financial institutions has made new financial products available to the State's businesses and households. Second, it has provided the State's businesses with greater access to national and world markets. Finally, it has spurred innovation in community banks; they are redoubling their efforts to offer services that are tailored to the specific needs of their customers.

On balance, then, I'd say that the benefits of tearing down geographic barriers far outweigh the costs. By creating a truly national financial services market, we'll give our financial firms the opportunity to hone their competitive edge. We'll also enhance financial stability through greater diversification of investment portfolios. And we'll provide American businesses and households with more and better choices regarding financial services.

### Dismantling Powers Restrictions

But that's not enough. The U.S. financial services industry faces a second potential handicap. I'll call this one "powers restrictions." By this, I mean restrictions on banks in areas of underwriting and selling insurance, corporate debt, and equity securities. I also mean restrictions on brokering and possibly investing in real estate. And I mean restrictions on investment banks, insurance companies, and real estate brokerage firms that limit their entering the banking business. In short, I see restrictions that prevent U.S. firms from offering a full range of financial services as potentially harmful to U.S. competitiveness.

Developments in European financial markets suggest that integrated financial service providers may be the wave of the future. In Germany, for example, financial firms that combine banking, investment banking, stock brokerage, and mortgage banking dominate the market. Many of Germany's so-called universal banks also own shares in commercial enterprises. And 1992 likely will move all of Europe toward Germany's highly integrated universal banking model.

This development won't surprise me in the least. In the global financial market of the future, firms that can offer a full menu of financial services may enjoy advantages over firms that are restricted to a more limited menu. First, integrated firms can use the technical expertise and information developed in providing one service to provide other services at a lower cost than a stand-alone competitor can. Likewise, integrated firms have opportunities to cross sell services to customers that stand-alone competitors do not. For these reasons, it may make sense to allow a bank that has a longstanding lending relationship with a company to underwrite that company's first public equity offering.

But current law in the U.S. essentially forbids this kind of combination. As a result, businesses and households may be paying a higher price or getting less service than they should.

Moreover, such barriers to competition lead to a waste of resources. And that's reason enough to eliminate them. But there may be another, more pressing reason to do so: in a word, 1992. Once internal barriers to trade and competition fall in Europe, competitive pressures will intensify.

This is not to say that U.S. firms will be left out. Even now, a number of American banks and investment banks are able to provide a fairly broad menu of services in Europe. But what concerns me is that in this country, banking, investment banking, and insurance still will be largely separate. As a result, European markets may gain a competitive advantage over U.S. financial markets. Since it's becoming easier for multinational firms to pick and choose the markets in which they raise and invest funds, I'm afraid the U.S. may stand to lose a considerable amount of business.

That's a price I'd rather not have to pay for clinging to Depression-era restrictions. Nostalgia just doesn't make good policy in the highly competitive environment we are facing.

### Deposit Insurance Reform

This point brings me to the third handicap U.S. firms suffer; that is, a deposit insurance system that permits excessive and financially-destabilizing risk taking. Don't get me wrong, deposit insurance has served depositors well for over fifty years. This calls to mind Bert Lance's immortal words, "If it ain't broke, don't fix it."

But it is broke. And I don't mean bankrupt, although, as you all know, the now-defunct FSLIC was indeed bankrupt. As outrageous and shocking as FSLIC's losses were, they merely are symptoms of the real problem. And the recently enacted legislation, necessary as it was, does not go far enough in addressing this problem. The real problem is not the riverboat gamblers, though there have been a few in the business, but the deposit insurance system itself. In a nutshell, the system is faulty in its very design.

After all, what private insurance company charges a flat fee to insure risks over which the insured has considerable control? One of the fundamentals of the insurance business is that you charge a much higher premium for these kinds of risks. And some risks you don't insure at any price. If you fail to follow these principles, you'll be out of business in short order because your customers won't drive as carefully, or keep flammable materials stored as safely, or test their products as diligently as they should.

Under the current deposit insurance system, insured institutions do not face higher premium costs for taking greater risks. For institutions that are close to insolvency, with little or no real capital at risk anymore, this pricing scheme is a "heads I win, tails you lose" proposition. When their investments turn out well, they enjoy the gains; when their investments do badly, the deposit insurance fund picks up the pieces. If that's not enticement to bet the bank, I don't know what is.

Bank and thrift regulators have had to work hard to keep a lid on these tendencies. One way they have done so is by restricting the kinds of activities insured institutions could get into. Consequently, our flawed deposit insurance system has been one very important reason legislators and regulators have been reluctant to allow banks to integrate with investment banks and insurance companies.

For forty of the fifty-plus year history of deposit insurance, the regulatory approach to managing risk taking was pretty successful. Of course, regulators were helped by two factors. First, bank and thrift charters historically were difficult to obtain, so owning a bank or thrift often was a lucrative venture, and no one wanted to risk killing the proverbial goose. Second, financial markets had not developed to the point where restrictions on insured institutions' activities hindered their ability to compete.

But all that has changed. Starting in the late seventies, competition in the financial services industry heated up, making it harder to turn a profit. And soaring interest rates in the late seventies and early eighties wiped out the capital of much of the thrift industry. Likewise, troubles in the farm belt and the oil patch pushed a number of banks over the edge.

Lacking the resources to close all the insolvent institutions, regulators let them continue in operation. The incentive to bet the bank became irresistible for more institutions than I care to count. So, it's no surprise that President Bush had to sign a \$166 billion bailout bill earlier this month.

Our goal should be to make sure no president ever has to sign another one. And unfortunately, chances are he or she will, if we don't reform the deposit insurance system.

Without specifying the exact features of this reform, let me set out three guiding principles. First, we need to encourage more market discipline of insured institutions. That is, bondholders' and perhaps some depositors' funds should be at risk, so that they will scrutinize the activities of risky institutions.

Second, bank regulators need to force the high-flyers in the industry to hold more capital. A sure-fire way to turn a bank into a high-flyer is to allow it to operate without any of its owners' money at stake. And finally, we need to get tough about closing insolvent institutions promptly. After all, they pose the greatest risk to the insurance fund because of the bet-the-bank temptation I mentioned earlier.

With adequate reform, we'll end up with depository institutions that are better capitalized and more cautious in their approach to risk taking. We'll also be able to give financial institutions more latitude in the kinds of activities they undertake. And we won't have to be quite so concerned about allowing banks, S&Ls, insurance companies, and investment banks to integrate if competitive pressures push them in that direction.

## Time to Act

In closing, I'd like to return to my original question. Are we helping or handicapping a key industry's ability to compete in global markets? I think the answer is that we are handicapping the financial services industry. But I also believe that by dismantling geographic barriers to domestic competition in banking, by addressing powers restrictions, and by reforming deposit insurance, we can go a long way toward removing the handicaps. Let's seize the initiative while there's still time.