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The 1990s:
A Crucial Decade for Financial Services

I. Introduction

A. It's not often I have the opportunity to address executives from the banking, S&L, and credit union industries -- in the same room, at the same time!

B. This only illustrates that in today's environment, distinctions among banks, S&Ls, and credit unions are rapidly disappearing.

C. So, today, I'm going to talk about the competitive pressures the *entire financial services industry* will face in the 1990s.

D. Specifically, I want to argue that international competition is going to set the tone for this industry in the 1990s.

1. Even if your institution has no international business, international developments are going to affect you in important ways in the '90s.

E. I plan to focus on three topics:

1. First, the broad trends that shaped the financial services industry in the 1980s.

2. Second, the developments in the 1990s that are likely to have major impacts on the industry.

3. And finally, I want to suggest some agenda items for financial reform in the U.S.

II. Turning first to the broad trends that have shaped the financial services industry,

A. I'm sure you'll all agree that competition has heated up in the last decade or so.

B. One way this has happened is geographically, primarily through what I'll call "interstate banking," for lack of a more inclusive term. But I'm referring to more than banks.

1. U.S. does not have full interstate banking yet, but as we all know, many states now allow out-of-state institutions to enter and compete with the locals.

2. And where state laws regarding entry remain somewhat

restrictive, out-of-state firms have found ways to compete; Citibank certainly has established a beach head in California already.

3. And even apart from any legal maneuvering, interstate banking is moving forward; there is competition in loan and deposit markets across state lines via toll-free telephone lines.

4. There's no doubt these developments have increased competition in local deposit markets.

5. At the same time, interstate banking also is leading to greater geographic diversification of risks.

   a. This, in turn, is reducing the likelihood of a repeat of the severe solvency problems institutions experienced in the farm belt and oil patch in the mid-1980s.

C. Geographic competition is also evident at the global level. In fact, many observers now are talking about the "globalization of financial markets."

1. Globalization is important in two respects.

2. First, it has brought a host of international competitors to our shores, heating up domestic competition.

   a. 6 out of the fifteen largest banks in California are now owned by foreign banks, 5 of which are Japanese.

   b. These foreign competitors traditionally have been formidable in wholesale markets, but they're now making significant inroads in retail markets, as well.

3. Second, globalization has tied U.S. credit markets more closely to events in other countries.

   a. For example, in recent months, rising interest rates in Germany and Japan appear to have put upward pressure on U.S. rates, as well.

   b. Globalization also means that American firms are raising funds abroad to an unprecedented extent.

D. But geographic competition isn't the only thing that has heated up; product competition also has increased.

1. Expanded deposit and lending powers turned S&Ls and credit unions into keen competitors for banks' retail business during the 1980s.

a. In California after mid-1980s, thrifts surpassed banks in terms of share of domestic deposits, although S&Ls recently have lost some of their competitive edge.

(As of January 1990, S&Ls had 53% of domestic deposits in California, compared to banks' 43%. But S&Ls' share is down from 55%, and banks' is up from 41% a year earlier.)

2. Moreover, nondepository competitors like Merrill Lynch and Pru-Bache have been offering highly competitive services for some time now.

E. There are a number of reasons competition in the financial services industry has heated up in recent years.

1. The most important is technological.

2. I am referring to the computer revolution, which dramatically reduced the cost of storing, processing, and transmitting data.

3. I'll give just a few examples of the way these changes have changed your business:

a. Cash management accounts. We wouldn't have these kinds of products today without cheap and powerful computer resources.

b. Shared ATM networks. The complexity of such arrangements would be unmanageable without relatively inexpensive technology.

c. Securitization. Packaging and selling loans is now a cost-effective proposition for almost all institutions, regardless of size, on account of inexpensive information technology.

4. I'm sure you could add other specific examples. But the picture's clear: improved information technology has made it easier and more profitable for financial service firms to compete on one another's turf.

F. Deregulation of deposit rates and loan products is another factor that has enhanced competitive pressures.

1. Prior to deregulation, competition took place mainly in terms of numbers of branch offices and other conveniences.

2. These dimensions tended to evolve slowly, and did not create the abrupt changes that are possible now.

3. Deregulation also may have helped to increase competition by allowing institutions outside a given local market to compete on the basis of price.

III. In the 1980s, as I've said, competition was the driving force in the financial services industry. In the 1990s, I expect competition to intensify. Two developments on the international front, in particular, are going to be key.

A. First, the influence of Japanese banks will continue to grow in world credit markets.

1. As recent experience indicates, Japanese banks have ready access to capital markets, while many U.S. institutions appear to be struggling to raise capital.

2. Japanese banks can use this advantage to build market share.

a. Already, the 10 largest banks in the world are Japanese.

3. Continuation of Japanese trade surpluses means the Japanese will play dominant role as suppliers of funds, particularly in U.S., given federal budget deficits.

4. In U.S., as I've already mentioned, Japanese banks are competing effectively for business of top corporations.

5. In 1990s, they're also likely to become formidable competitors in retail deposit markets and in consumer lending.

B. A second, and more important development that will shape the financial services industry in the '90s is ... Europe 1992.

1. Now, you might be wondering what developments across the Atlantic could possibly mean for financial services in the U.S.

a. In a word, the answer is plenty.

b. European banks and European financial markets are going to become a lot more competitive.

c. And if U.S. institutions don't rise to the challenge, we're going to find ourselves with a shrinking share of the world financial pie.

d. Let me suggest two ways in which 1992 is going to affect us.

2. As you know, 1992 is the deadline for the creation of a unified internal market in Europe.

   a. This will involve removing geographic barriers to the flow of goods and services within the European Community.

   b. So, the first point I want to emphasize is: 1992 will enable European banks to operate freely throughout the continent, giving them a "domestic" market of 325 million people.

   c. Talk about opportunities! Opening the European market will mean:

      (1) opportunities and incentives to develop new and more competitive products;

      (2) opportunities and incentives to develop more cost-effective service delivery systems; and

      (3) opportunities to diversify geographic risks more cheaply.

   d. Quite a picture. But what about the U.S.?

      (1) Well, under current laws, in 1992, U.S. institutions will be limited to patchwork of individual states, comprising significantly less than the total U.S. market.

      (2) And even if all states were to allow nationwide entry, we'd *still* have a less-efficient delivery system than in Europe.

         (a) Because interstate branching is prohibited.

3. Second, many believe 1992 is going to make the '90s the decade of the universal bank.

   a. By "universal bank," I mean a bank that combines lending and deposit-taking with investment banking, stock brokerage, insurance, and mortgage banking, among other things.

   b. This is the model in Germany.

      (1) In fact, many German universal banks also own shares in commercial enterprises.

   c. Many observers conclude that 1992 will move all of

Europe toward this highly integrated, universal banking model because it's more efficient:

(1) Integrated firms use expertise and information developed in providing one service to provide additional services at lower cost.

(2) Integrated firms have opportunities to cross-sell that stand-alone firms don't have.

(3) Finally, integrated firms can hold a corporation's debt *and* equity, thereby helping to control credit risk and reducing the cost of financing.

d. If you're an American company looking for cheapest way to raise funds, or if you're an American investor looking for the best return on your investment, the European market is beginning to look more and more attractive.

e. Particularly since current laws in the U.S. forbid universal banking.

f. The bottom line is that U.S. financial markets stand to lose a lot of business

(1) because corporations can pick and choose the markets in which they raise and invest funds.

(2) And it's only a matter of time before households enjoy some of the same opportunities.

C. Now, I don't want to imply that only the big, universal banks will survive in the 1990s.

1. Even in Germany, a substantial number of small, locally-oriented banks and thrifts are thriving.

2. But the point is, smaller institutions can't afford to be complacent.

a. The trend towards universal banking means that the regulatory distinctions among specialized financial service firms increasingly won't offer protection against competition.

b. Finding true market niches to serve will become ever more important.

3. At the same time, however, profitable market niches are going to get harder to find if we fail to meet the universal

banking challenge in this country and allow increasing portions of our financing business to shift to the European market.

IV. These observations about international competition in the 1990s lead naturally to my third topic, financial reform in the U.S.

   A. There may have been a time in the not-so-distant past when purely domestic considerations could dictate financial policy.

   B. But all that has changed.

      1. Revolution in information technology has made most geographic and product distinctions among institutions obsolete.

      2. In 1990s, then, competition both from the Japanese and the Europeans increasingly will dictate pace and direction of change in U.S. financial markets.

   C. Consequently, the "turf-battle" approach to financial regulatory policy is becoming a luxury we can ill afford.

   D. Instead, it's time to begin thinking more globally about the best way to restructure our financial system. Here are some issues we need to look at:

      1. Interstate banking. (Again, I'm using this term generically.)

         a. Forcing institutions to enter out-of-state markets via another, separate institution just isn't efficient.

         b. Of course, nationwide branching would increase competitive pressures, and this represents a challenge, particularly for smaller institutions.

      2. Regulatory reform.

         a. Our current regulatory system, with its multiple and overlapping agencies, is cumbersome and inefficient.

         b. We need to ask ourselves whether it makes sense at the federal level to have three separate bank regulators -- the Fed, the Comptroller, and the FDIC.

         c. Moreover, because distinctions between S&Ls and banks are fast becoming obsolete, we need to rethink the role of the OTS, as well.

      3. Dual chartering.

a. The decisions we make regarding interstate branching and federal regulatory reform also will have implications for what happens to our dual chartering system.

4. Powers restrictions.

a. U.S. institutions increasingly are competing head-to-head with one another. And together, they're facing increasing competition from banking organizations in Europe and Japan. So, can we afford to preserve product-related barriers in the provision of financial services?

b. It's probably even worth examining whether the separation of banking and commerce needs to be so airtight as it is currently.

5. Finally, deposit insurance reform.

a. I see this as a precondition of other financial reforms.

(1) Congress isn't likely to give institutions expanded powers without also ensuring that adequate safeguards are in place.

b. To me, the key to meaningful deposit insurance reform is prompt closure or reorganization of insolvent institutions.

c. This means that forbearance must go; no institution should ever be considered too big to fail.

d. At the same time, it also means that we can reform deposit insurance without having to reduce the $100,000 deposit insurance ceiling.

V. I've laid out a full agenda of reform issues for the 1990s.

A. But if we fail to confront the issues head-on, we'll end up with another round of turf-battle financial policy.

B. And while we're fighting among ourselves, we'll be losing the real battle in global markets.

C. Whether we like it or not, international competition, particularly from the Europeans and the Japanese, increasingly will challenge U.S. financial markets.

D. If we want to preserve a healthy and vibrant financial services industry in this country, we need to rise to the challenge.