

For release on delivery
10 45 a m , HST (4.45 p.m. EDT)
October 11, 1988

Innovation and Regulation of Banks in the 1990s

remarks by

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before the

American Bankers Association

Honolulu, Hawaii

October 11, 1988

It is a pleasure to have the opportunity today to address members of the American Bankers Association. As you may recall, a minor mishap in securities markets came between us last year. I have one request at the outset--if anyone knows how the stock market closed today, don't tell me until I've finished.

That we can joke a little about the events of a year ago is a tribute to the resilience and adaptability of our financial markets and economy. Nonetheless, such occasions do remind us of the speed and suddenness with which markets can move today, and the potential impacts of such movements on investors and financial institutions.

Even before last October's events, there was increased concern about potential instabilities in the financial system. Such concern arose as a consequence of the major changes in the financial landscape that have occurred in this decade--changes that in some cases are continuing and even accelerating. I shall spend only a few minutes reviewing them, concentrating on their implications for the business of banking, and for the regulation of banks and other depository institutions. As you adapt, so must we, and that is the focus of my remarks today.

At the very beginning I would highlight two points. First, the goals of depository institution regulatory policy may be stated quite simply--to avoid the

risk of systemic failure of the insured depository system, to promote competitive and efficient capital markets, to protect impartiality in the granting of credit, and to prevent extension of the safety net to nonbanking activities. Second, change is inevitable and, while it may bring the potential for increased risk, if properly managed, it is also likely to bring improvements in economic and social welfare. The regulator's job is to adapt to change in ways that preserve its benefits while maintaining the stability of the financial system.

Key Changes in Recent Years

Over the past decade our financial landscape has experienced a number of key, and often interconnected, changes. Advances in computer and telecommunications technology have enabled both borrowers and lenders to more easily, and at lower cost, obtain and use credit- and market-risk information. In important ways, this has displaced and substituted for some of the key traditional economic functions of banking. Many new financial products have resulted from this technological revolution in information processing that challenge traditional bank loans and funding techniques. It seems reasonable to assume that the trend toward direct investor-borrower linkage, or more securitization, will continue.

Moreover, financial markets have become increasingly international in scope, and the resulting intensity of competition has put increased pressures on the

profit margins of many depository institutions. When combined with the revolution in information processing, the increased speed with which assets can be shifted around the world in liquid markets has accentuated the need for effective risk management policies by both depository institutions and regulators.

A significant element in financial change, the deregulation of interest rates and selected product lines in the United States and some other nations, has improved the overall competitiveness and efficiency of capital markets. But they have also removed hitherto protected sources of funds to depositories, potentially exposing them to increased interest rate risk, and added pressures on profit margins. Similarly, the breakdown of barriers to interstate banking in the United States, while providing opportunities for geographic diversification and more open access to new markets, also has increased pressures on some institutions. Today, all but five states have passed some form of liberalized interstate banking law. There is every reason to believe that the competitive pressures brought about by the deregulation of interest rates, product lines, and geographic limitations will continue.

Finally, macroeconomic events such as the sharp increase in inflation and interest rates in the late 1970s, the severe recessions of the early 1980s, the steep decline in oil prices, and the October 1987 stock market crash, have, as seems evident, induced people in general, and

financial market participants in particular, to expand their expectations regarding the potential volatility of asset prices and other economic variables. In other words, these events have not only caused severe contemporaneous problems, they have also injected a new and higher degree of uncertainty, or risk, into projections of the future. This reaction highlights the fundamental interdependencies between the macroeconomy and the financial markets that any policymaker--but especially one in the central bank--must recognize. For all the new techniques for shifting risk around the financial system, the ultimate safety and stability of that system depends on the stability of the economy on which it is based, and that economy cannot itself behave in a stable and predictable fashion if the markets in which claims on saving and capital are allocated are subject to waves of concern about key participants.

Key Components of Policy Response

The implications of these changes for the regulation of depository institutions are varied and complex. I believe the way to begin responding to both today's and tomorrow's economic environment is to fortify the natural "shock absorbers" of the financial system--capital and liquidity--and concurrently to make better use of market and market-like incentives to discourage excessive risk-taking at individual depository institutions. There must be a symmetry of risk for owners of depository institutions; those who stand to gain substantially if the

institution is successful must also stand to lose substantially if outcomes are not so favorable. Surely, one lesson from the experience with some troubled depository institutions in recent years is that unbalanced incentives to assume risk, arising when the federal insurer absorbs losses while the owners reap profits, can lead to destabilizing behavior.

The key to engendering market incentives, and at the same time providing shock absorbers for depository institutions, is to require that those owners who would profit from an institution's success have the appropriate amount of their own capital at risk. Capital acts as a buffer against unexpected shocks to a firm, and thereby helps to insulate both individual firms, and the system, from risk. There is no better way to ensure that owners exert discipline on the behavior of their firm, than to require that the owners have a large stake in that enterprise. The need for larger shock absorbers and for increased private incentives to monitor and control risk are the fundamental reasons why increasing the amount of capital in the depository institution system has been a major goal of Federal Reserve regulatory policy in the 1980s. To the extent that we succeed, we will have begun to lay a solid foundation for the 1990s.

Some may argue that raising capital standards will put banking organizations at a competitive disadvantage. This strikes me as short-sighted. Well-capitalized firms

can be counted on to be around in the future, and thus worthy of customers' willingness to establish long-term relationships. Moreover, while the capital ratios of bank holding companies generally have been rising during the 1980s, they still tend to be considerably below those at nondepository financial firms. In many cases, this no doubt reflects real or imagined protection by the federal safety net. This tendency toward over-reliance on the safety net by both owners and depositors has inhibited, and in some cases may have eliminated, the private market signals that would have made much less likely many of the portfolio problems now facing numerous depository institutions. Thus, the safety and soundness of the financial system requires that banks have adequate capital.

For many banks this means increased capital requirements. I recognize that some of these banks, not feeling market pressures to raise capital ratios, may consider increased capital requirements unnecessarily burdensome. However, given the existence of the federal safety net, market signals regarding the level of capital may not be appropriate from a broader perspective. The safety net has the effect of overriding some forms of market discipline, and the implied partial backing of the federal government for some bank funds means that incentives for banks to maintain adequate capital are weakened.

Bank reluctance to raise equity in capital markets may also be based, to an extent, on comparisons of book and

market values of equity and the apparent consequences of a shortfall in market value for shareholder dilution. But the relevant consideration is clearly enhancing the market value of the firm over time. High capital banks will be the ones that can react to the changing environment and profit from new opportunities.

Regulatory policy can and should do more than merely raise the level of capital. A risk-based system of capital standards should help to deter excessive risk-taking by individual banks, and the greater capital costs imposed on higher risk banks will imply a fairer distribution of capital requirements within the banking system. These principles are well-known and well-utilized in private markets--higher risk borrowers are charged higher interest rates on loans in money and capital markets, and higher risk insurees are charged higher premiums by insurance companies.

Bank regulators took a major step forward this past summer, when virtually all of the major industrial nations agreed to implement a risk-based capital system by the end of 1992. Everyone realizes that the scheme adopted is far from perfect. Indeed, in recognition of the fact that the framework does not take account of all the risks to which banks may be exposed, I believe that banking organizations generally should be encouraged to operate above the minimum capital ratios specified in the accord. This is especially true for institutions undertaking rapid expansion, or those with operational or financial

characteristics that are of supervisory concern. In addition, it is clearly the intention of all concerned to improve the risk-based system over time. For example, work currently is proceeding on how interest rate and liquidity risk might be included.

But to dwell on the accord's shortcomings really misses the important points. We know the current system has serious deficiencies, and the risk-based capital accord clearly is an improvement. The risk-based accord establishes the principle of requiring that a bank's capital ratio reflect its degree of risk. The accord also recognizes explicitly that off-balance sheet activities impose risks on the bank and therefore deserve a capital charge. In the risk-based accord a viable forum has been created in which international cooperation on bank regulatory matters can be designed and implemented. In an increasingly interdependent world, there can be little doubt that this represents important progress. The accord significantly reduces the competitive inequities to which U.S. banks have been subject as American bank capital standards rose relative to those in other nations. Finally, in the long run the accord may serve as a model for international cooperation in regulating other aspects of banking and even other financial intermediaries.

The accumulation of adequate capital and the successful implementation of a risk-based capital system would certainly go far toward helping ensure the stability

of the system of depository institutions in the 1990s. However, the information revolution is changing the very nature of financial intermediation in ways that, if certain current statutory and regulatory policies are maintained, in all likelihood will lead to a diminishing future role for banks. This, in turn, will make it difficult for banks to obtain the capital they need.

The key reform needed to respond to the information revolution is, of course, repeal of the Glass-Steagall separations of commercial and investment banking. The provision of investment banking services, particularly to corporate clients, is on the cutting edge of the information revolution. Repeal of Glass-Steagall would allow banking organizations to evolve with technology and the market, and would provide real public benefits from increased competition and the realization of possible economies of scale and scope. Alternatively, maintenance of the current environment will result in our nation incurring unnecessary costs as banking organizations' specialized resources are transferred into other activities or businesses, not because of banks' unwillingness to compete or innovate, but simply because of an inflexible statutory and regulatory structure. In response to these concerns, the Board has approved bank holding companies engaging in certain hitherto ineligible securities activities in a separate subsidiary of the holding company. However, it

clearly is preferable that clarifying and comprehensive legislation be enacted at the federal level.

While repeal of Glass-Steagall is certainly one of the Board's highest priorities, it is worth recalling that there are public policy concerns with such an action. These concerns relate to preventing the transfer of increased risk to the bank, to protecting impartiality in the granting of credit, and to preventing extension of the safety net to securities activities. The desire to achieve these goals has led the Board to support locating certain expanded nonbanking activities, including expanded securities powers, in separate subsidiaries of bank holding companies. Successful implementation of this strategy requires the construction and maintenance of effective firewalls between a bank and an affiliated securities firm. Thus, the Board has required that firewalls be maintained as a condition of regulatory approval for expanded securities activities, and the Board has supported most of the firewall provisions of the Financial Modernization Act passed by the United States Senate. We believe the holding company approach is the best available, can be tested in the "real world" of financial institutions, and, if it proves as effective as we expect, should serve as a foundation on which to build more generally for the 1990s and beyond.

I would emphasize that we must attempt to coordinate our policies in such a way that each can be seen as a piece of an integrated whole. In particular, the

incentives for financial institution owners and managers, the public, and even regulators must be consistent within a given policy and compatible with the incentives provided by other regulatory actions. It would be inefficient and counterproductive, for example, if, on the one hand, we attempted to increase shareholder discipline on bank holding company risk-taking by increasing capital requirements, while, on the other hand, we reduced lenders' discipline by extending the federal safety net to holding company debtholders.

The degree of policy coordination I am suggesting is extremely difficult to achieve, in part because incentives are often complex or subtle, and in part because general policies are sometimes adopted in response to specific events alone. Indeed, it may be impossible to achieve complete consistency in some cases because the goals of policy are themselves contradictory. However, unless we make a strong effort to be consistent across market participants and policies, we run the risk of achieving little or no progress.

More adequate capital, risk-based capital, and increased securities powers for bank holding companies would provide a solid beginning for our efforts to ensure financial stability. These reforms would not mean, however, that no banks would fail, or that merger and acquisition activity would cease. Competitive pressures from international banks, out-of-state domestic organizations,

new depository institutions, and nonbank financial firms will continue and likely increase. Various sectors of our and the world economy inevitably will experience unexpected changes in supply and demand. There will always be some owners and managers whose fraudulent behavior or simple incompetence puts their institutions at risk.

These arguments suggest other important policy responses to our changed financial environment. First, the timely closing of insolvent firms is vital if we are to avoid the misallocations of credit, the distorted competitive incentives, and the increased costs to the deposit insurance funds that result when a failed institution is allowed to operate with the public's money.

Second, the Federal Reserve supports efforts to limit deposit insurance protection to depositors in the insured intermediary, and not to extend protection to the creditors of the parent holding company. Such efforts correctly focus safety net protections on the depository institution and provide holding company creditors a strong incentive to control risk-taking at both the bank and holding company level. Indeed, without a program that places the risk where the profit potential is--the private sector--it is questionable whether banking organizations should be empowered to take on new risks. To do so would be inconsistent with the broad policy of increased market discipline that, as I have argued, must be part of a responsible public policy that both permits banks to respond

to the changes in the financial environment and maintains financial stability

Clearly, the policy responses that I could discuss with you have not been exhausted. I could have mentioned, for example, continuing Federal Reserve efforts to control risk in the payments mechanism, or the proposal of some observers for market-value accounting at banking organizations. We shall always need accurate and up-to-date monitoring of the risk position of individual institutions through the supervisory process.

However, I believe that the responses I have outlined today constitute the essential core of any set of policies designed to deal with the financial landscape of the 1990s. The future is inherently uncertain, and we surely shall face new and unexpected challenges in the years ahead. I believe that we can face the future with confidence if we have the wisdom and the will to lay the proper groundwork.