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Remarks by

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for a

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I am delighted to appear before this distinguished audience at an institution whose announced purpose is to prepare students for lives of leadership and service that is today honoring a man whose life so exemplifies such virtues The James A Leach Chair of Banking and Monetary Economics was conceived " to provide students with an opportunity to learn about the important role that banking plays in the economic development of the Midwest " Jim Leach's name surely should be associated with such an endeavor since he clearly understands the relationship of banking to economic development and of the necessity of prudent finance He also understands, and has constantly reminded us at the Fed, of the critical role smaller banks — and he would say, well–capitalized smaller banks — have played not only in state economic growth, but in the prosperity of the nation

In recent months, events — and reflections on what I might talk about today — have led me to think more about the nature of the U S banking structure and the importance of the U S banking system to our economy I have reviewed and re–read a good deal of banking history, and have taken a closer look at the statistics I have come away from all of this with a renewed sense of the importance both of our dual banking system and of banking structures such as those in Iowa

The U S economy has many characteristics that have contributed significantly to its growth and to the widespread diffusion of its product among American citizens These include a vast area and highly productive population, unparalleled natural resources, limited government regulation, a reliance on markets and entrepreneurial innovations, and — critically, I would argue — a flexible and dynamic financial system That system could neither have developed to its present state nor could it be long maintained without the very responsive and creative banking system that underlies it

I am often bemused when both foreign and American observers compare the U S and foreign banking structures, note the uniqueness of the American system, and conclude that since it is so different it should be changed These critics seem unwilling to consider the possibility that these very differences are an important reason for the dynamism of the U S economy that has given us such a high standard of living That is is not to say that our banking system has no blemishes, that it needs no reform, or that technology and market forces will leave it unchanged in the future But to change our bank structure just to make it look like that of other countries seems misplaced at best and likely harmful to our economy

Our banking system is, in fact, the envy of the world, not only because of its ability to finance growth and otherwise serve customer needs, but also because of its ability to rebound from crises that may well have devastated more rigid systems Recall just a few years ago the bank failure rates, the losses, the deteriorating asset quality, the capital depletion, and the unwillingness to extend credit But since late 1989, U S banks have diverted over $109 billion from earnings to loan loss reserves, absorbed $106 billion of charge-offs against those reserves, raised over $46 billion of new equity capital, and in the last two years earned record profits, reaching the highest overall capital position since the early 1960s and have become willing lenders once again That is just one more remarkable record, this one so soon after the worst banking crisis since the Great Depression

Our banking system is distinguished by two structural hallmarks the very large number of smaller banks and the division of the supervision and regulation of banks between the states and the federal government To be sure, the advent of federal deposit insurance has meant that all banks have some federal oversight But, the dual banking system has nevertheless remained strong and healthy Indeed, the

state regulated sector — long felt to be an historical artifact — continues not only to survive but to increase its relative position

With only minor exceptions, the banks in the early years of our republic were state chartered and state regulated From the very beginning, there was significant congressional distrust of banks with their little understood, and to many fearful observers, fraudulent ability to create money by issuing notes in excess of their specie reserve Banks at that time financed their assets mainly by issuing their own circulating promissory notes rather than taking deposits, and there was such a shortage of "money" to finance trade that the sheer economic need for those notes overcame the fears of banking in the minds of federal legislators There was considerably less fear in the state legislatures, which, as now, were closer to the needs of local trade Indeed, by the very early 19th century the number of state banks began to show a significant increase

Through those early years, each bank received its specific charter directly from the legislature, a cumbersome, time–consuming, and politically charged procedure Many of these banks were, in fact, chartered to finance a specific project—like a railroad, a canal, or a bridge And, as you might suspect, given the now well–known problems of loan concentration, their failure rate was high With the closing in 1836 of the Second Bank of the United States — the immediate federal precursor of the Federal Reserve that, among other things, tried to keep the state banks from issuing excess notes by gathering them up and presenting them for specie payment — states began to look for ways not only to establish banks more easily (and put more money into circulation) but also to have a safer system In the process, the states created their first real banking innovation the so–called free banking laws—first proposed in New York and first enacted in Michigan in 1837

Under free banking laws, no special legislative charter was required Rather, anyone could apply for and receive a bank charter so long as a certain minimum capital was raised and certain assets (usually, but not always, state bonds) pledged dollar–for–dollar behind the bank's note issuance The virtual automaticity produced the "free" part of the title The collateral and capital rules added "safety" As soon as the first note could not be redeemed, the state would close the bank, redeem the notes with the pledged assets and, if necessary, the bank's capital By 1860, 18 of the 33 states had free banking and 3 more had bond–secured note issues

Many historical writers have not treated free banking well Often it was called "wildcat" banking because of the charge that, in fact, unscrupulous bankers placed these banks in distant locations —"where only wildcats go" — issued notes, and left with the assets when noteholders, who finally arrived at these distant locations, sought redemption By implication, if not explicitly, poor state regulation was charged

More recent research suggests that free banking worked far better than the older textbooks indicated Once the note collateral rules were modified to value collateral at market value rather than at par and the permissible collateral options were narrowed, losses to noteholders of free banks became modest Moreover, the vast proportion of bank failures reflected not fraud, but sharp drops in prices of state bonds that made up a large part of bank portfolios When such failures — whose initiating causes were outside the banking system and beyond its control — occurred, they were generally not followed by runs

The state innovation of collateralized notes and minimum capital requirements was copied in total by the framers of the National Bank Act of 1863 National banks were not created solely in order to develop a common U S currency,

although the costs and inefficiencies of tracking values of the myriad of state bank notes were no small problems Rather, Secretary of the Treasury Salmon P Chase was intrigued with the possibilities of a captive market for treasury debt that would result from a requirement that the collateral behind national bank notes be treasury securities In addition, because of a tax on state notes, national banks would be the only set of banks free to issue notes In short, the pressures of Civil War finance melded nicely with the application of a banking principle developed by the states Note collateral and capital requirements became the hallmark of the new national banks

While state banks were taxed out of the note–issuing business by the National Bank Act, deposits — which had always been among U S bank liabilities — had already grown to exceed notes by the mid–19th century Indeed, it might be argued that the National Bank Act did the state banks a favor by forcing them to focus on the growth area of banking deposits and payments by checks As one might readily anticipate, the number of state banks initially declined sharply after 1863 as banks changed charters to continue their note–issuing capability Indeed, five years after the act was passed, there were only 250 state banks compared with over 1,600 national banks. But by the last decade of the 19th century, the number of state banks had grown to exceed the number of national banks, a structure that has continued without exception to this day

The increase in the number of U S banks — both national and state — in the late 19th and early 20th Centuries was truly phenomenal, reaching a peak of over 30,000 in the early 1920s As I noted earlier, the large number of individual banks is one of the special characteristics of U S banking — so special that no other G–10 country has anywhere near the number of commercial banks per capita of the U S

The large number of individual U S banks has helped to create a highly competitive system, characterized by a large number of smaller banks In my judgment, this structure has been critical in producing a banking system that is the most innovative, responsive, and flexible in the world U S banks have had to have those characteristics in order to survive in a market economy subject to rapid change and periodic stress

But it is not just these characteristics that have been so important It is often overlooked that the large number of small banks in the U S banking structure has also played an important political and cultural role in the success of the U S economy Our nation has historically feared the concentration of financial power That is why we went for so long in the 19th and 20th Centuries without a central bank Indeed, the very structure of the Federal Reserve System reflects the desire for diffusion of power and internal checks and balances Our populist roots would, I am sure, simply not have permitted a banking system characterized by a small number of large banks If our system had evolved along those lines, it is quite possible that our banks would have been far more shackled by regulation than today We owe much to the small banks that helped us avoid such a result

We are also in the debt of the dual banking system, in part because the states have fostered innovations that simply could not have occurred as rapidly — if at all — had only federal regulation existed I have already noted that the free banking approach was the model for the National Bank Act More recently, the NOW account, which has allowed millions of consumers to receive interest on their transaction accounts, and was a major factor leading to the fortunate disappearance of national interest rate controls, was invented by a state-chartered savings bank in Massachusetts Likewise, as I noted, interstate bank holding company laws, which

have been enacted in some form by all the states except Hawaii, and have allowed bank holding companies to compete and diversify geographically as never before, originated in a rewriting of the Maine banking laws Adjustable rate mortgages are yet another example of innovations pioneered at the state level that have yielded major benefits for both consumers and producers of banking services

Today, in many, if not most, regions we continue to owe the community banks of our country for their creative financing, their innovative skills, and their knowledge and support of their local communities — all the while maintaining a level of capital and prudence that over time these institutions have learned is central to their continued success Iowa itself is a state with virtually all community banks active in loans to small businesses and farms, as well as community support activities During last year's floods, many banks in Iowa offered lowered loan rates and deferred payments Indeed, business failures declined by a third in Iowa in 1993, despite the flood, reflecting, among other things, the close cooperative work between the local banks and business communities over that difficult period Iowa bankers over the period also collected critical information for state and federal agencies and acted as a conduit to provide a great deal of needed information to their customers and communities

It is their knowledge of local markets and their economic and community participation that makes small banks so important to our economy To be sure, a consolidation trend is currently underway in U S banking This trend, I suspect, will be accelerated by the shift from partial interstate *banking*, authorized now in all but one state, to national interstate *branching*, which in different forms has passed both houses of Congress Some observers believe that this trend will spell the end both for small banks in the U S and for the dual banking system I do not In all likelihood, there are

going to be thousands of banks in the U S for as long a period as I can foresee, and I believe that most of the smaller ones will choose to be state chartered

This judgment rests in part on the fact that extensive research over the years suggests that economies of scale are quite limited in banking Aside from efficiency associated with size, recent research indicates that in each size class of banks there is wide variation in cost structures, variation that simply overwhelms any economies of scale *Some banks in each size class are just better than others* in that size class at cost control, risk management, marketing, and other aspects of managerial expertise Moreover, there seems to be little evidence that a well–managed, large, efficient acquirer can transfer that advantage to an acquired firm, at least in the early years of a merger In addition, the evidence continues to confirm that large banks entering a new market by acquisition are usually not able to expand the market share of the acquired firm, and often lose market share to *de novo* local banks Indeed, successful new entry into markets with existing large banks (provided the local economy is strong) is a characteristic of U S banking that has not changed over the years, nor do I expect that it will

In fact, entry into the banking industry has become easier over time In the not–too–distant past, in order to obtain a new bank charter, one had to demonstrate that the banks in the market were not meeting the needs of the market, that the new bank would be profitable within a certain time period, and that the new bank would not harm the existing banks Frequently, as you might expect, the existing banks protested the application for the new bank and were able to block entry Now, most of those requirements are gone

All of this is not to deny that there is a definite and growing market need for large banks offering sophisticated services to a national and international market And technology will, I think, continue to expand the efficient scale at which all organizations, especially financial firms, can operate But most businesses and households do not need the types of services that only large banks can provide The basic bank product lines, as well as those evolving — mutual funds, security brokerage, and, yes, even insurance sales — smaller banks can and do offer Plus, small banks can add to the product mix what larger banks often cannot personalized service, local market knowledge, and easy access to the officers of the bank Nonetheless, the smaller banks of the future, I suspect, will choose to adopt many of the innovations now being developed by large banks, just as large banks have learned by their own experiences not to lose the focus on the customer that small banks have long understood

For these reasons I believe that the U S banking system, despite consolidation and interstate banking and branching, will continue to have a large number of small banks in profitable competition with a group of regional banks and a much smaller number of very large banks I suspect that there will never be very many truly nationwide banking organizations Despite the fact that interstate banking began to evolve nearly twenty years ago, today there are only six banking organizations operating in ten or more states, and two of these had a head start in multistate operations that were grandfathered by the Bank Holding Company Act of 1956

Most of the smaller banks will, I believe, maintain their state charter And, as in the past, I suspect that the Federal Reserve will continue to be a strong supporter of the dual banking system For some time we — as well as the FDIC — have sought

an examination process partnership with the state regulators Currently the Fed has cooperative agreements with 37 states, calling for either joint or alternate year exams Our experience has been quite positive in these programs, and more importantly, the state banks have benefited from the dual approach

One of the reasons that we participate in the cooperative arrangements is the quality of the state supervision we find in the accredited states Based on failure rates, the evidence suggests that state banks compare favorably with national banks, apparently benefiting from having both state and federal supervision. For example, from 1986 through 1992, almost surely the most traumatic period in U S banking since the Great Depression, the national bank failure rate was considerably greater than that of state banks While failure rates alone are not a sufficient measure of supervisory success, these data do speak well of state supervision

Indeed, while the benefit of two sets of eyes examining banks — federal and state, the hallmark the dual banking system — has no doubt played an important role in the strength of state banks, failure rates are not the indication I would choose for measuring the contribution of banks to economic progress An important source of growth in our economy is risk–taking and risk–taking cannot occur unless it is financed Lenders who take no risk provide very little input to our economy's growth Informed risk–taking, at bottom, is what the bank franchise is about To take risks requires judgment, knowledge of the customers, and capital Capital is critical because there will be mistakes and bad luck and sometimes those mistakes and bad luck will produce losses that the bank must absorb to survive Sometimes those losses, however, will exceed capital But, bank failures — with some exceptions — are a sign of a banking

system doing its job and accepting risk Deposit insurance is designed to protect innocent third parties from such failures and the art of central banking — including the use of the discount window — is to eliminate the spreading of failures that can cause disruption of markets with associated impacts on the output of goods and services The external costs of bank failure thus must be constrained in a modern economy, but my point is that the optimum bank failure rate is not zero, especially if we have an infrastructure in place to limit the effect of bank failures on the economy

The tension that exists between necessary risk–taking and the need to maintain a safe and sound financial system, has broader implications for overall economic development Risk–taking, as I noted, is a necessary condition for wealth creation In a market economy, competition and innovation interact, those firms that are slow to innovate or to anticipate the demands of the consumer are soon left behind The dynamics of the American economy are truly impressive Capitalist market economies such as ours are driven by what Professor Joseph Schumpeter, a number of decades ago, called "creative destruction " By this he meant the continuous obsolescence and abandonment of goods and services, replaced by newer ways of doing things, newer products, and novel engineering and architectural insights The result has been an economy of continuous retirement of factories and equipment and a reshuffling of workers to new and different activities Indeed, what is not fully understood about the American economy is the extent to which it "churns" as new activities and new jobs continuously displace older ones It is nothing short of startling to realize that in the United States, approximately 300,000 workers a *week* lose their jobs or are laid off, matched normally by a somewhat higher figure of newly created job openings

Such job turnover is facilitated by the extraordinary large number of new small businesses that come into existence every week and month, offset by a comparable number of establishments that fail, down–size through mergers, or are otherwise abandoned Market economies in that sense are continuously renewing themselves Innovation, risk–taking, and competition are the driving forces that propel standards of living progressively higher

The pace of churning differs by industry, but it is present in all At one extreme, firms in the most high–tech areas must remain constantly on the cutting edge, as products and knowledge become rapidly obsolete Many products that were at technology's leading edge, say five years ago, are virtually unsalable in today's markets In high–tech fields, leadership can shift rapidly In some markets where American firms were losing share just a few years ago, we have regained considerable dominance In one case, U S firms have seized a commanding lead in just four years in the new market for notebook computers, and accounted for almost 70 percent of U S sales in 1993, nearly four times the figure for Japanese firms

More generally, it appears that the pace of dynamism has been accelerating As one indication, the average economic life expectancy of new capital equipment has been falling The decline in the average life of equipment purchased in the interval since 1980 is triple the decline of the life of equipment purchased in the similar preceding interval In addition, telecommunications technology is obviously quickening the decision–making process in both financial and product markets

In such a rapidly changing marketplace, the agile survive by being flexible One aspect of this flexibility has been the spread of "just–in–time" inventory controls at manufacturing firms Partly as a result of innovations in inventory control

techniques, the variability of inventories relative to total output has been on a downtrend

In this dynamic environment, the attainment of rising living standards in the future depends critically on our ability to increase productivity growth, and that will require greater amounts of investment — in human capital and in research and development, as well as the more tangible plant and equipment

It will also require a viable, adaptive and innovative financial system But, such financial systems operating in rapidly changing market economies are subject to intervals of stress, during which financial system disruptions could threaten the economy Bank regulators thus must assure that the evolving financial structure in the United States and abroad contributes not only to economic growth, but also to economic stability

An essentially benevolent financial environment has emerged in the years between the stock market crash of October 1987 and early this year, characterized by steadily rising stock and bond prices interrupted by only a few periods of modest retrenchment The associated capital gains and relatively low offering rates on bank deposits contributed significantly to the rapid inflows to mutual funds The inflows were further strengthened by the deceptive stability in quarter–to–quarter returns, and the associated sense of low risk Such tranquil markets also fostered the active and rapidly increasing use of financial derivatives, used in increasingly sophisticated ways to manage risk. The essential function of these instruments is to unbundle risk and allow it to be transferred to those most willing and able to manage it While no doubt some participants may misuse these tools, these new risk management techniques and products have improved the efficiency of our financial system

However, that very efficiency may well work against regulatory authorities during periods of financial stress These instruments are vehicles for implementing arbitrage strategies that reach across national borders to link cash markets throughout the world With these tighter links in place, a financial shock can be transmitted far more rapidly than in generations past Financial crises in the early 19th Century, for example, particularly those associated with the Napoleonic Wars, were often related to military and other events in faraway places A London investor's speculative position could be wiped out by a military setback, and he might not even know about it for days or even weeks And, when the news did become available not all financial market participants knew about it instantaneously, slowing — and perhaps moderating — the impact on financial markets

By the turn of the century, news moved more rapidly than it did in the early part of the 19th Century, but its speed certainly cannot match that in today's financial markets The environment now facing the world's central banks — and, of course, private participants in financial markets as well — is characterized by instant communication Complex financial instruments — derivative instruments, in one form or another — are being developed to take advantage of the gains in communications and information technology Derivatives activities would not have flourished as they have without these technological advances They could not be priced properly, the markets they involve could not be arbitraged property, and the risks they give rise to could not be managed properly without high powered data processing and communications capabilities Of course, the links between technology and financial innovation do not operate in only one direction The demands of financial engineers and managers have prompted further technological gains, with enormously valuable spillovers to the management of financial portfolios in general

In recent weeks the world–wide financial system has been subject to considerable stress, with substantial capital losses in the combined stock and bond markets in the United States. The decline in bond prices was no doubt exacerbated by significant net redemptions in bond mutual funds, as fund shareholders reacted to declines in net asset values when interest rates backed up Some of the adjustment, both in securities and mutual funds prices, can be viewed as an unavoidable correction to what had become an unsustainable situation in which higher relative rates seemed to be riskless The decline in securities prices has also in turn severely tested the risk management systems created to support derivative activities We regulators are bound to learn a great deal about their strengths and weaknesses just as we gained insights from the strains that accompanied the 1987 stock market crash and the European Monetary System crises of 1992 and 1993. As best we can judge at this moment, the risk management systems have worked reasonably well Some firms have suffered setbacks that depressed earnings, but the announced losses to date amount to a small fraction of the capital that both regulators and counterparties require of major derivatives dealers However, its too soon to be conclusive More evidence will emerge in the weeks and months ahead, which will communicate a significantly greater understanding of how these risk management systems are working, not only to regulators, but, far more importantly, to the senior managements and internal risk controllers at those institutions that have invested so heavily in advanced financial technologies Moreover, recent and forthcoming reports and congressional hearings, in part at the behest of Jim Leach, will provide additional insight and analysis with which to evaluate the lessons from experience and the large number of proposals that have been forthcoming recently

These observations have perhaps taken us over too wide a range, but they underline the changes in banking markets that bankers in London, Tokyo, New York, and, yes, Des Moines are, and will be, facing

Let me simply conclude by indicating again how delighted I am to take part in this dedication of the James A Leach Endowed Chair in Banking and Monetary Economics The chair is well named for its purpose and well located in a banking environment in which the banks have demonstrated the best in America's banking The small and regional banks, such as those in Iowa, have played — and continue to play — a significant role in the political and economic development of our nation The larger banks have much to gain from reviewing their experience The sound principle of risk management so evident in community banking in Iowa could well be absorbed with profit by those playing in the wider more complex world of international finance

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