For release on delivery
3 40 p m EDT
September 19, 1994

Remarks by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Boston College Conference

on Financial Markets and the Economy

Boston, Massachusetts

September 19, 1994

The subject I will be discussing today — the future of the financial services industry — is of critical importance to the future of the U S economy Financial institutions not only play a central role in determining the allocation of real resources, they also provide the infrastructure for the day–to–day payments and transfers without which our modern world economy would grind to a halt As we consider the future of financial intermediaries, the primary goals of public policy should be kept in focus to ensure a system that makes the maximum contribution to the growth and stability of the economy A critical challenge facing policymakers is thus to test the compatibility of our evolving laws and regulations with the changing technological and market realities in order to ensure that these goals are achieved

The fundamental forces shaping our financial system are quite clear Perhaps the most profound development has been the rapid growth of computer and telecommunications technology Technological change has lowered the cost and broadened the scope of financial services, making it increasingly possible for borrowers and lenders to transact directly, and for a wide variety of financial products to be tailored for very specific purposes But technology has been a two–edged sword for financial institutions On the one hand, virtually all of the new products, from derivatives to securitized loans, would not have been possible without the computer and telecommunications revolution On the other hand, technology has played a critical role in the creation of substitutes for many traditional products of depository institutions, from retail deposits to short–term credit for high quality borrowers The boundaries of technological change are being pushed ever outward and will continue to facilitate innovative responses to changing demands for financial services that would have been considered impossible only a short time ago

A second important force shaping the financial system has been the rapid pace of financial globalization Most observers are well aware of the dramatic change in the

last three decades in the scale of operations of branches and subsidiaries of banks outside their own borders But the degree of international integration goes far beyond such offices, encompassing sharply expanding cross-border asset holdings, greatly increasing trading in real and financial assets, and higher bank and nonbank credit flows Rapid growth in cross-border banking has been supported by the low-cost information processing and communications technology that has improved the ability of customers to avail themselves of borrowing, deposit, or risk management opportunities offered anywhere in the world on a real time basis NAFTA, GATT, and the pace of technological change should encourage the continuation of these trends

The third development reshaping financial markets — deregulation — has been as much a reaction to technological change and globalization as an independent factor Moreover, the continuing evolution of markets suggests that it will be increasingly difficult to maintain some of the remaining rules and regulations established for a different economic environment While the ultimate policy goals of economic growth and stability will remain unchanged, market forces will continue to make it impossible to sustain outdated restrictions, as we have recently seen with respect to interstate branching

The three forces — the technological revolution, globalization, and deregulation — have transformed the way financial institutions, especially banks, carry out their unchanging function measuring, accepting, and managing risk Nowhere is that more clearly evidenced than in the financial derivatives market Although some types of derivative instruments have existed for hundreds of years, the scale, diversity, and complexity of financial derivatives activities have greatly increased in the last fifteen years

The economic function of derivative contracts is to allow risks that formerly had been combined to be unbundled and transferred to those most willing and able to assume and manage each risk component Banks, other financial institutions, nonfinancial businesses, and governments have become increasingly aware of the necessity of managing financial risk, and indeed have discovered that, if left unmanaged, such risks could jeopardize their ability to perform successfully their economic function Derivatives are the vehicles that allow all lenders and borrowers to adjust their risk profile at low cost And the present scale and complexity of these instruments could not exist without the use of computers and the rapid expansion of telecommunications They could not be priced properly, the markets they involve could not be arbitraged properly, and the risks they give rise to could not be managed properly without high powered data processing and communications capabilities

In addition to the dramatic changes associated with derivatives, the pressures unleashed by technology, globalization, and deregulation have inexorably eroded the traditional institutional differences among financial firms Within and between countries, direct borrowing in capital markets has become an increasingly close substitute for bank credit Information has become available to a wider array of potential investors at low cost In such an environment, institutions are competing directly in more and more markets, and it is clear that those institutions still subject to outdated statutory and regulatory restrictions increasingly find market and instrument limitations onerous

Nonetheless, not all institutions would prosper as, nor desire to be, financial supermarkets Many specialized providers of financial services are successful today and will be so in the future because of their advantages in specific financial services Moreover, especially at commercial banks, the demand for traditional services by smaller businesses and by households is likely to continue for some time And the information revolution, while it has deprived banks of some of the traditional lending

business with their best customers, has also benefitted banks by making it less costly for them to assess the credit and other risks of customers they would previously have shunned Thus, it seems most likely that banks of all types will continue to engage in a substantial amount of traditional banking, delivered, of course, by ever improving technology Community banks, in particular, are likely to provide loans and payments services via traditional on–balance sheet banking Indeed, smaller banks have repeatedly demonstrated their ability to survive and prosper in the face of major technological and structural change by providing traditional banking services to their customers The evidence is clear that well–managed smaller banks can and will exist side by side with larger banks, often maintaining or increasing local market share Technological change has facilitated this process by providing smaller banks with low cost access to new products and services The record shows that well–managed smaller banks have nothing to fear from technology, deregulation, or consolidation

Just as the forces of technology, globalization, and deregulation have forced market participants to respond, regulators and policymakers must re–evaluate their positions As a first step, policymakers must address the implications of continuing a government safety net for depository institutions By safety net, I mean the government guarantee of certain deposits, access to the discount window, and access to Fedwire for rapid, government–guaranteed payments transfers

There are two problems with the safety net First, it both distorts the allocation of real resources and exposes taxpayers to significant loss By giving governmental assurances to depositors and other creditors, the safety net enables depository institutions to have larger and riskier asset portfolios than would otherwise be possible The second problem with the safety net is that its existence has made some reluctant to support removal of existing statutory prohibitions and limitations on bank activities,

because of their fear that the safety net would thereby be extended, to the detriment of nonbank competitors and at the risk of increased taxpayer liability

These problems can be addressed in one of three ways by eliminating, by extending, or by reducing the safety net Removing the safety net from insured depository institutions has apparently little support in the body politic It is presumed to have provided measurable benefits to the U S economy by virtually eliminating financial panics and their real economic impact Moreover, it has a strong political constituency and its subsidy value is already capitalized in both banks' equity and banks' liability values Alternatively, extension of the safety net to other financial institutions would spread the corrosive impact of subsidies that distort market signals and increase taxpayer potential liabilities

Accordingly, I have been led to the practical, but effective, strategy adopted by the reforms since the late 1980s, which has been to blunt the importance of the safety net in bank decisionmaking Higher capital standards, risk–based capital, prompt corrective action, and more frequent on-site examinations — as imperfect as they are — have sought to induce bank behavior that is more like what would occur if there were no safety net The continued success of these reforms is critical to the future of the financial services industry By blunting the economic drawbacks of the existing safety net, they allow for less constrained participation by banks in the ongoing evolution of the financial system That is, the removal of limitations and prohibitions at insured depository institutions has become more feasible because their relaxation would not cause the spread of an invidious subsidy Indeed, the FDICIA–type reforms were originally intended to be coupled with expanded activities for banking organizations One–half of the actions was taken, the other half is overdue

With the authorization of interstate branching, the most pressing reforms needed are expanded insurance sales and repeal of Glass–Steagall Insurance sales are virtually riskless, and our experience over several years with Section 20 affiliates and the increased dealing activities of banks in derivatives, securities, and foreign exchange, suggests that the risks resulting from repeal of Glass–Steagall are manageable The period in which Section 20 securities affiliates of banks have operated and over which expanded trading activities have occurred encompasses intervals of rapidly changing interest rates, the associated changes in mortgage prepayment rates, and abruptly changing exchange rates Risk management and internal controls at Section 20 affiliates and in trading activities conducted by banks have been tested by these experiences and have been found to be generally strong These control systems continue to evolve and include sophisticated techniques to measure market risk and specialized credit and liquidity risk management staff

Federal Reserve examiners have evaluated limit structures and actual risk–taking by Section 20 affiliates and in the trading activities of banks, and found risk levels to be moderate and the operations generally profitable The most significant quarterly losses in a Section 20 affiliate have involved trading in mortgage–related instruments, whose values and liquidity can change rapidly as prepayment flows vary with changing interest rates When interest rates rose this year, daily trading losses on a wide range of instruments rose sharply, but effective risk controls and management decisions rapidly curtailed positions and associated losses On balance, for the first half of the year, the combined trading activities of banks and their Section 20 affiliates were generally profitable, although below the exceptional performance of 1993 Only three of the largest fifty banking organizations suffered a cumulative net loss on their combined trading and underwriting activities in the first half of this year, and those losses were not only insignificant, but were all related to mortgage–backed securities

Nevertheless, some observers have argued that, even if safety net and risk concerns are not compelling, the case for expanded banking activities has been weakened recently because banks have done so well that they do not need any relief in order to compete for market share Moreover, recent research conducted within the Federal Reserve System, as well as by the American Bankers Association, has suggested that, when properly measured, banking's share of financial intermediation has not declined by as much as is suggested by conventional indicators Indeed, by some measures banks appear to have more than held their own This new research attempts to incorporate not only traditional statistics, such as bank loans, but also the estimated "credit equivalent" amounts of the many new off-balance sheet activities, estimates of certain off-shore banking operations, and other adjustments to the data that attempt to account for the effects of technological change and globalization These results are interesting and provocative, and give quantitative meaning to something we all knew — that banks are adapting to, and participating in, the changes sweeping the financial services industry, as well as being severely challenged by them

In the last analysis, however, whether banks are expanding, holding their own, or losing market share is largely irrelevant — unless the changing share is being driven by outdated legal barriers or subsidies It has always seemed to me that there should only be two tests for evaluating potential permissible activities at banking organizations (1) will the activity facilitate the efficient deployment of assets, capital, and human resources to meet the public's need for financial services, and (2) is the risk acceptable on safety and soundness grounds?

Our experience with Section 20 affiliates and trading activities of banks suggests that securities and trading activities meet these tests This experience also clearly demonstrates that supervision by the SEC of Section 20 affiliates, and the banking agencies of both Section 20 affiliates and bank trading activities, has more than met the

challenges during periods of market stress Moreover, it seems obvious to me that the public is well served by additional competitors offering underwriting services These benefits would be particularly strengthened as banks use their expertise for regional and smaller customers

With or without new activities for banking organizations, policymakers need to ensure that supervision and regulation is consistent with evolving market realities and with the *fundamental function of financial institutions* — the measurement, management, and taking of risk The risk-taking function of banks and other financial institutions is at the center of their economic role Economic growth requires risk-taking by businesses and hence risk-taking by those that finance them If banks avoid risk, they avoid contributing to economic growth In my view, the pendulum in recent years has swung too far, with many observers seeming to seek a zero failure rate However, the very nature of banking suggests that the economically optimal degree of bank failure is not zero, and, in all likelihood, not even close to zero

Such a position does not imply that risk–taking by banks and other financial institutions should be unconstrained Failure has costs not only for those directly connected with the failing institution, but also potentially for the macro economy A systemic risk disruption — caused, for example, by a bank failure or other adverse news that leads to a loss of confidence in large parts of, or even the entire banking and financial system — would have serious implications for the real economy A fundamental goal of public policy is to avoid systemic failure

Bank supervisors, and the lawmakers who define supervisors' objectives, thus face a critical trade-off Prudent risk-taking must be encouraged, but excessive risk-taking deterred Risk–based capital and prompt corrective action are consistent with these dual goals by placing explicit costs on excessive risk-taking But, such

regulations cannot replace on-site examination, one of the objectives of which must remain the review and evaluation of credit risk — the old-fashioned oversight of credit standards and procedures

The evolving financial firm, however, is becoming so complex that it not only challenges our ability to write laws and regulations, but — more important — is leading to overly complex rules and regulations that challenge the ability of managers to manage At least part of the solution to the increasing complexity in bank risk positions may be to rely less on the writing of complicated and highly specific rules that apply to all banks, and to concentrate more on the development of common conceptual frameworks and flexible supervisory procedures that can accurately distinguish risks on a bank-by-bank basis Such an approach is entirely consistent with the view that banks must hold sufficient capital to make the deposit insurance guarantee moot, and that the core of bank supervision must continue to be the on-site evaluation of the individual bank

But, I believe the focus of individual bank evaluation needs to shift somewhat The basic "unit of supervision" should become increasingly the evaluation and stress-testing of a bank's overall risk position, along with evaluation of the current value of individual bank assets Indeed, the evaluation of risk should become, within the supervisory process, as important as assessment of the value of capital via the on-site examination of the quality of assets and the adequacy of loan loss reserves However, no matter how skilled supervisors themselves become at evaluating risk, the first line of supervisory defense must be the quality of the risk management systems used by banks themselves The banking supervisory agencies in the United States, and their counterparts abroad, have already begun to focus on the *process* by which portfolios are selected and risks managed rather than solely on the instruments held at a point in time

Let me sum up The future of the financial services industry seems surprisingly clear because the forces that are shaping it can be readily observed Those forces — technology, globalization, and deregulation — are creating *choices* for institutions to compete directly with other entities over a wide range of markets, using, if they wish, complicated and sophisticated instruments Some entities will choose to operate at large scale, over national and world markets, in virtually every financial instrument, others will specialize in more limited geographical markets and/or products All will find the competition much more intense as barriers to entry collapse and pressures mount to use new technologies

While the future of the financial services *industry* seems clear, the role that will be played by banks is less certain Legislators and policymakers will have to *choose* whether they will permit banks to participate fully in the financial future So far banks have been adept at finding ways to better serve their customers by taking advantage of new technologies and markets However, I am concerned that they may be reaching the limits to efficient and low–cost ways of doing so The unanswered question is will we continue to rescind and modify outdated laws and regulations in order to permit banks to serve the needs of their customers? The experience of recent years suggests that we can modify restrictions so that banks can participate more fully and efficiently in the evolving financial services industry, while at the same time minimizing systemic risks and potential taxpayer costs

* * * * * *