For release on delivery
8:30 AM PDT (11:30 AM EDT)
Wednesday, October 7, 1981

Banking: A Framework for the Future

Remarks by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

at the

Annual Convention

of the

American Bankers Association

San Francisco, California

October 7, 1981

It is always a particular pleasure for me to have the opportunity to address the bankers of this country. Our interests are inevitably intertwined. To achieve our objectives for monetary policy, we in the Federal Reserve must work through our banking and financial intermediaries. That, together with your key role in the economy generally, justifies -- indeed requires -- a certain amount of regulation. You, in turn, have a natural interest that the process of regulation not be stifling -- that monetary control, or concern over banking stability, not place you in a competitive straitjacket, at the expense of growth and profitability. The fact is our common interest coincides: that the nation's banks -- your banks -- be efficient, competitive, and strong.

It is in that context that I want to discuss with you some personal thoughts on steps we can take to support that common purpose. The challenge is particularly demanding at a time of unprecedented innovation in the financial sector, and particularly severe pressures on financial markets.

You are all acutely aware of the changes in the financial environment forced by irreversible technological change -- change reflected both in the development of new institutions and a breaking down of traditional geographic or institutional barriers to competition. Old concepts of what is banking and what is not are blurred, and even national borders are losing their significance. The extraordinary level of interest rates has itself created powerful new incentives for innovation and competition.

Today, we have an array of financial institutions and instruments that were simply unknown a decade or two ago. The typical customer no longer feels so dependent on his local bank for financial services. But at the same time, financial transactions are still all ultimately settled through the banking system. There has been an enormous increase in the volume of these payments, which flow ever more quickly through a relatively narrower base of demand deposits and reserves.

In the circumstances, it is no wonder that many bankers are concerned about the place of their individual institutions, the relative position of their industry, and whether they can compete effectively in the future. But it would be hard to argue that the stability and strength of banks and banking are not also a legitimate, continuing concern of public policy.

In striking the necessary balance in regulation, let me establish one point at the outset: the facts do not warrant a sweeping conclusion that commercial banks have become a shrinking element in financial markets, marked for extinction by a steamroller of regulation. Contrary to the impression of many, there is simply no clear evidence that the relative importance of commercial banks to the credit markets has trended down. The share of total credit extended in the United States by commercial banks is just about the same now -- roughly 30 percent -- as it was three decades ago; indeed, it has shown little distinct trend since the turn of the century.

Nor is there evidence that banking has become appreciably more concentrated in the U.S. during the postwar period. In fact, the largest 50 banks accounted for a slightly lower share of total banking assets, about 37 percent, in 1980 than they did in 1960.

What is true is that some other financial intermediaries have grown relatively faster -- but at the expense of direct purchases of securities or extensions of credit by individuals and businesses. In other words, financial intermediation as a whole has grown. As a result, banks, large and small, find themselves challenged by more institutional competitors, frequently large and strongly capitalized, offering a range of financial services. Within banking, foreign-owned institutions now have a significant share of the market. But, the large U.S. banks have, conversely, greatly expanded their activities abroad.

What statistics cannot adequately reflect are qualitative changes within the banking world. The great depression nurtured a highly conservative and disciplined attitude toward lending, liquidity and leveraging. These conservative attitudes were often reinforced by public policies -- policies which also provided banks with special protection, such as deposit insurance and protected markets.

The conventional wisdom of those years -- and it carried well into the postwar period -- has perceptibly changed. Part

of the change reflects the stronger competitive pressures induced both by public policy and the natural workings of the marketplace. The attitudes of bankers and supervisors alike have also reflected the general environment of unprecedented growth and stability. Risks are judged differently by a generation never faced with general economic adversity and accustomed to deposit insurance and "activist" governmental intervention in the event of stress. Perhaps most insidiously, inflation gradually came to be looked upon as both "normal" and the potential solvent for financial difficulty.

Whatever the mixture of causation, profit margins of the larger banks have tended to narrow and return on capital has been maintained only by greater leveraging, even as most conventional indicators of credit risk have increased. Narrow margins help drive a search for volume, and aggressive lending policies are maintained during periods of monetary "ease" and "stringency" alike. Internal liquidity has been depleted, and "liability management" substituted. Banks properly minimized the risk of that shift by resorting to floating interest rates on their loans and greater attention to matching maturities on assets and liabilities. But the result has been to push more of the risk of interest rate volatility on the customer -- a risk that now needs to be taken into account in credit judgments.

Through all of this lies the sense among bankers that they are caught up in competitive forces beyond their control -- among domestic banks, with foreign banks, and increasingly, with

nonbanking institutions -- and that, in meeting the competition, banks must labor under the handicap of excessive and unfair regulation.

The agenda before us in banking and financial regulation is, in essence, simple enough. We, as a nation, want to preserve and nurture the strong competitive forces that assure our financial system remains the most efficient and innovative in the world. We also want to maintain the discipline necessary for the strength and solidity of our banking institutions -- institutions that are the essential nucleus of the financial system. The question is: how do we combine the two?

In its specifics, the details of designing a regulatory roadmap for the future are enormously complex and controversial. We have more than a taste of that in the deliberations and decisions of the Depository Institutions Deregulation Committee; the ultimate goal is clear enough, but the pace and particulars of the effort need to take account of the severe earnings pressures on thrifts and on some commercial banks. For some, the process of phasing out interest ceilings is too fast; for others it is too slow; and for all -- myself included -- it seems too complicated and cumbersome. Given all the vocal particular interests, perhaps it is inevitable no one group will be entirely happy.

But perhaps that process is also illustrative of the nature of the difficult transition to a new regulatory structure.

That transition requires a hard look at reality; a willingness to discard what is no longer workable or necessary; an insistence on preserving that which is essential; and above all, a coherent vision of the future.

It is in this context that it may be useful for me, from my viewpoint as a central banker, to set out a frame of reference for approaching the issues. My comments fall under five points:

(1) While the scope of commercial banking services needs to be redefined, a basic dividing line between banking and commerce should be retained.

(2) The same regulatory ground rules should apply to functionally equivalent services provided by different institutions -- the much discussed "level playing field."

(3) The regulatory system must be cost-sensitive, recognizing that excessive costs simply drive business elsewhere.

(4) A climate should be provided in which a variety of institutions -- large and small, urban and rural, generalized and specialized -- can flourish.

(5) The regulatory framework must promote the fundamental strength and soundness of our banking institutions.

In approaching this agenda, there may be a few who, out of frustration, would propose a wholesale dismantling of the present legal framework. There is some justice in the proposition that a structure inherited from the financial cataclysm of the 1930's is outdated -- outdated by both the growth of competition with nonbanking institutions and by the revolutions in technology.

As my first point suggests, however, the laws and traditions of this country embodying a separation of banking and commerce still seem to me fundamentally valid. That tradition rests on concepts that concentration of economic power can be dangerous, that the potential for conflicts of interest in a service so vital as the extension of capital and credit should be minimized, and that there is a special public interest in the safety and soundness of our banks. In some respects, those concerns are reinforced by technological changes -- the advances in communications and data analysis - that so enhance the capacity and reach of financial institutions.

While retaining the division of labor between banking and commerce, I also recognize the line between banking and other financial services has become blurred. It needs both redefinition of the appropriate border, and clear recognition that some substantial overlapping in the provision of services by different types of institutions--bank and nonbank--can enhance competition.

The field for possible expansion is broad indeed, including, for example, some forms of insurance, management consulting, travel services, at least some securities activities, money

market funds (and comingled agency accounts), and data processing and transmission. I will not attempt to suggest here precisely where the lines should be drawn, but only the scope of the debate. For instance, the question of commercial banks selling commercial paper or underwriting of municipal revenue bonds, which the Federal Reserve Board has long supported, seems to me quite different from underwriting corporate stocks, where questions of ownership, potential conflicts of interest, and risk are much greater.

My second point -- the level playing field -- of course implies that banks entering new service areas will have to meet appropriate regulatory standards applying to other providers of those services. More relevant to most of you is the corollary-- that institutions providing banking services should be subjected to regulation comparable to that on banks.

Reserve requirements are a case in point. If you assume, as we do, that monetary policy must be able to control the supply of money through reserve requirements, we should be able to reach those instruments that are functionally similar to transaction balances in banks, whether or not they happen to be located in an institution called a "bank" or a "savings and loan" -- or a money market mutual fund. But in other cases, where the regulation may have no clear purpose, competitive equality demands it be removed; for instance, the most powerful argument for eliminating ceilings on interest paid by depository institutions is the competition from non-regulated institutions, and the open market itself.

Reserve requirements may also provide an apt example for my third point -- cost-sensitive regulation. As you well know, the cost and competitive implications of reserve requirements applying to member banks alone forced adoption of compulsory reserve requirements for all depository institutions. But with the incentive of high interest rates, we can also now observe a proliferation of new instruments, within and outside banks, that serve the functional purpose of transactions balances but escape the reach (and cost) of reserve requirements. While we should keep the reserve requirements to the lowest levels practicable, the scope for reduction may be limited, given both the needs of monetary policy and the enormous volume of payments flowing through reserve accounts each day. In the circumstances, logic points toward the possibility of paying interest on required reserve balances. Implications for Treasury revenue, as you know, have deferred consideration of that approach, but over time reliance on reserve requirements as a source of government revenue seems to me questionable.

When regulation is necessary, we need to consider more vigorously the practical application of what might be called "regulation by exception" as a means of reducing costs. The banking regulators have taken some steps in this direction by relating the intensity or frequency of examinations to the past performance of the institution, and in the examination process itself. We in the Federal Reserve are now exploring whether

more can be done to reduce the time-consuming process of approving mergers, take-overs, or new activities for banks and bank holding companies.

Several recent court decisions bearing on bank acquisitions point up the problem. On the one hand, the decisions would seem to suggest more liberal standards for approval -- that is, the Federal Reserve should not consider competitive factors going beyond general antitrust standards; on the other hand, those same decisions would apparently require an even more intensive "antitrust-type" investigatory effort and analysis as an essential part of the decision-making process.

An approach in merger cases that we are exploring internally to deal with this situation would be to establish clearer general guidelines, based largely on statistical measures of concentration, to establish a presumption for approval or disapproval. In this framework, more merger proposals could be reviewed in a simple, speedy regulatory process, with a presumption of approval for proposals within the guidelines, assuming the institutions are in a satisfactory financial condition. Only applications exceeding the general guidelines would be subject to rigorous, and necessarily more prolonged, review. The practicality of this approach has not been tested, and before adopting it we would want to provide you with an opportunity to comment. But we do want to be alert to opportunities for "regulation by exception" as they arise in our regulatory activities.

My fourth point looks toward diversity in the provision of financial services. Traditionally in the United States, this concern has provided much of the rationale for geographic limits on banking, and for a separate legal and regulatory structure for banking and thrifts. Both technology and market incentives are breaking down those legal restrictions. The question at issue is not whether we want interstate banking or active competition between banks and thrifts; in the marketplace, we obviously have it in very large measure. Moreover, depository institutions are competing every day with other, nonbank providers of the same or similar services. The issue, it seems to me, is how the strong forces for further change can be channeled most constructively, permitting time for adaptation and fair opportunities. In the process, as I suggested to you last year, there should be opportunities for greatly simplified regulatory procedures for the smaller institutions.

The present strains in the thrift industry have required us to face some of these issues without delay. In the area of inter-industry and interstate acquisitions, we have sought a limited answer, consistent with time for adaptation and adjustment, through specific legislation authorizing the regulators to arrange such acquisitions only in failing institution situations. The only alternative in some instances would be to use our existing and broader powers to permit bank holding companies to take over thrifts, potentially leading to more rapid and radical change. I urge your support

for the so-called Regulators Bill, which in a real sense provides time for the thorough review and analysis that proposals for more fundamental change deserve.

I have saved for last discussion of a point which seems to me fundamental to all the rest, because it goes to the basic strength of the banking system. Banks, of course, must be free to take risks -- and to fail. Through the years, we have developed an elaborate official "safety net" designed to prevent the transmission of failure through the system. That safety net has served us well. But we should be alert to the other side of the coin -- to the extent the safety net insidiously comes to be viewed as a substitute for discipline and prudence of the individual banker, we will end up with a fragile and vulnerable banking system.

Much of what I have said here today suggests new competitive opportunities and more freedom for banks. But with that opportunity goes responsibilities that no sound banker can shirk.

Prudence has many dimensions. But I must tell you in all candor that I am uneasy about the slippage in one key measure of banking strength -- the capital position of some of our large banking organizations over much of the postwar period. The turbulent financial environment of today, the rapidity of change, and the risks apparent in even such relatively straightforward activities as the money transfer business emphasize the importance of capital adequacy.

I fully recognize and welcome the conscientious efforts of most large banks in the past year or two to maintain and improve their capital in a difficult environment. But my concern can be illustrated by trends over a longer period. Since 1970, the capital ratios of the largest banks in the nation -- those over $5 billion in assets -- have dropped more than 20 percent. At year-end 1970, equity capital as a percent of total assets, was 5.34 percent for the largest banks, close to what was then a postwar low. By the end of 1980, this ratio had dropped to 4.12 percent. There has been, I am glad to say, no comparable decline among smaller banks.

The Board expressed its concern about capital ratios a little more than a month ago. We urged banks generally to avail themselves of every opportunity to strengthen their capital positions, and emphasized that: "In exercising its responsibility under the Bank Holding Company Act, the Board will monitor closely the capital position of large banking organizations in connection with their future expansion plans."

It is implicit in all I have said that commercial banking has a crucial role to play in our economy. In some respects, it has been over-regulated; any vital industry needs to be able to seize competitive opportunities. At the same time, the financial strength and stability of your industry is bound to be of special concern to your central bank simply because your responsibilities in our economic life are so great, and because you are the transmission belt for monetary policy.

It is in times like these, when pressures and strains in financial markets are so evident, and when the burdens on monetary policy are so heavy, that the strength of our banking system is tested.

It will come as no surprise to you that I believe that dealing with inflation must be the crucial ingredient in any successful economic program. With varying degrees of success, efforts have been mounted against inflation in the past. But the hard fact is those efforts were not pressed strongly enough, or long enough, to turn the tide. The result is that the problem over time has gotten worse -- and along with higher inflation, our general economic performance has deteriorated.

Now we have a new opportunity. We can begin to see some encouraging signs of progress against inflation. But I am well aware that the battle is far from won. Winning that battle will require maintaining control on the expansion of money and credit, bringing growth in the monetary aggregates down to amounts compatible with price stability. With inflation still high, that process has been accompanied by great strains and distortions in credit markets, and severe pain in credit dependent sectors of the economy.

In these circumstances, we all know that the essential job of monetary policy will be much easier -- with less strain on interest rates, and on financial markets, on homebuilders and homebuyers, and on smaller businesses -- to the extent the Administration and Congress press ahead with the effort to cut spending and

balance the loss of revenue from tax reduction. In those respects, the toughest part of the job remains ahead. In approaching it, we need to recognize there is no safe, painless alternative to the fiscal and monetary objectives we have set for ourselves. Indeed, a sense of retreat would not only aggravate the present problems, but could set back the prospects for restoring growth and stability for years to come.

Let me not leave any lingering question in your minds. The Federal Reserve has no intention of backing away from its commitment to reduce inflation by restraining and disciplining the process of money creation. We intend to see it through.

* * * * * * *