Mr. Greenspan looks at the need for financial reform and the importance of a decentralized banking structure in the United States Remarks by the Chairman of the Board of Governors of the US Federal Reserve System, Mr. Greenspan, at the Annual Convention of the Independent Bankers Association of America in Phoenix, Arizona, on 22/3/97.

As always, it is a pleasure to address this convention of the Independent Bankers Association of America. This is the sixth year I have addressed this convention, and during that time four separate Congresses have debated how best to reform the financial system. I last spoke to you about financial reform in 1994, in Orlando, and it is clear that the real world occurrences of the past three years have not diminished the relevance of those words. Therefore, I shall reemphasize some of those thoughts today in the context of legislative proposals that are now before the current Congress.

Let me begin by reiterating the essential thrust of the Federal Reserve's position regarding financial reform. We believe that any changes, either in regulation or legislation, should be consistent with four basic objectives: (1) continuing the safety and soundness of the banking system; (2) limiting systemic risk; (3) contributing to macroeconomic stability; and (4) limiting the spread of both the moral hazard and the subsidy implicit in the safety net. My remarks today will focus primarily on the macroeconomic and risk implications of financial reform and how, in particular, such reform must enable community banks to maintain their critical role in the macroeconomy.

The importance of the community bank

Our banking system is the most innovative, responsive, and flexible in the world. At its core is a banking structure that is characterized by very large numbers of relatively small banks -- more than 7000 separate banking organizations. This banking structure is very different from that of other industrialized nations -- for example, there are less than 500 banks incorporated in England, Germany, and Canada combined. To be sure, the very largest U.S. banking organizations account for the lion's share of banking assets. Still, no one institution controls more than 6 percent of total domestic banking assets in the United States.

This highly decentralized, highly diverse banking structure is almost certainly the direct result of our market economy itself. Indeed, it is revealing that the first edition of Adam Smith's Wealth of Nations was published in 1776, the year of the birth of our nation. Our market-driven economy, founded on Smith's principle of "natural liberty" in economic choice, and the banking structure that evolved within that economy, have proved to be remarkably resilient. During the banking crisis of the late 1980s -- a crisis which was felt in banking systems throughout the world -- more than one thousand U.S. banks failed. But less than a decade later, loan loss reserves and bank capital at U.S. institutions stand at their highest levels in almost a half century. Moreover, the reestablishment of equilibrium regarding safety and soundness in our banking system was accomplished without costing the taxpayers a penny.

To be sure, the effects of the banking crisis, as well as the ongoing pace of consolidation within the industry, have reduced the total number of banking organizations by more than a third since 1980. Nevertheless, we remain a nation characterized by a large number of smaller community banks -- just as we are a nation characterized by a diversity and small average size of our nonfinancial businesses. Moreover, one cannot easily imagine nor desire that the decentralized, diverse nature of our banking system will fundamentally change any time soon. There is, of course, a strong connection between our banking structure and the nature of our small-business-oriented economy. Smaller banks traditionally have been the source of capital for small businesses that do not generally have access to securities markets. In turn, small, new businesses, often employing new technology, account for much of the growth in employment in our economy. The new firms come into existence often to replace old firms that were not willing or able to take on the risks associated with high-growth strategies. This replacement of stagnating firms with dynamic new firms -- what the economist Joseph Schumpeter called the "perennial gale of creative destruction" -- is at the heart of our robust, growth-oriented economy.

It is this freedom to take on risk that characterizes our economy and, by extension, our banking system. Legislation and regulation of banks, in turn, generally should not aim to curtail the predilection of businesses and their banks to take on risk -- so long as the general safety and soundness of our banking system is maintained. As I have said many times, regulators and legislators should not act as if the optimal degree of bank failure were zero. Rather, policymakers must continually assess the tradeoff between, on the one hand, protecting the financial system and the taxpayers, and on the other hand, allowing banks to perform their essential risk-taking activities, including the extension of risky credit. Optimal risk-taking on the part of our banks means that some mistakes will be made and some institutions will fail. Indeed, even if a bank is well-managed, optimal risk-taking means that such a bank can simply get unlucky. Either through mistakes of management or through the vagaries of economic luck, bank failure will occur, and such failure should be viewed as part of a natural process within our competitive system.

Just as regulators and legislators must accept failure, they also must not, in their zealousness to maintain a safe and sound financial system, artificially restrict competition among banks or between banks and their nonbank counterparts. For example, we should not repeat the experiment with "micromanagement" of bank activities that was embodied in the 1991 FDICIA legislation, much of which was repealed in the 1994 banking legislation. In this regard, so long as we do not place artificial regulatory roadblocks in their way, I am not overly concerned with the ability of our smaller banks to compete with their large, regional or national counterparts. Our research shows that, when a large bank enters a new market through acquisition of an existing smaller institution, typically lending to small businesses initially declines. But then existing community banks take up the slack by lending to the borrowers spurned by the larger organization. Indeed, several community bankers have commented that they welcome the entry of large institutions into their markets via the acquisition route, seeing it as an opportunity to acquire some of the customer base that often is lost by the newly acquired bank.

The dual banking system and the importance of choice of federal regulators

Just as our decentralized banking structure is a key to the robustness of our macroeconomy, a key to the effectiveness of our banking structure is what we term the dual banking system. Our system of both federal and state regulation of banks has fostered a steady stream of innovations that likely would not have proceeded as rapidly or as effectively if our regulatory structure were characterized by a monolithic federal regulator. For example, the NOW account was invented by a state-chartered bank. Also, the liberalization of prohibitions against interstate banking has its origin in the so-called "regional compacts" that permitted interstate affiliations for banking companies in consenting states. Adjustable rate mortgages are yet another example of innovation at the state level that has benefitted financial institutions and their customers.

Just as important as the fostering of innovation is the protection the dual banking system affords against overly rigid federal regulation and supervision. The key to protecting against overzealousness in regulation is for banks to have a choice of more than one federal regulator. With two or more federal regulators, a bank can choose to change its charter thereby choosing to be supervised by another federal regulator. That possibility has served as a constraint on arbitrary and capricious policies at the federal level. True, it is possible that two or more federal agencies can engage in a "competition in laxity" -- but I worry considerably more about the possibility that a single federal regulator would become inevitably rigid and insensitive to the needs of the marketplace. So long as the existence of a federal guarantee of deposits and other elements of the safety net call for federal regulation of banks, such regulation should entail a choice of federal regulator in order to ensure the critical competitiveness of our banks.

The job of a banking regulator, difficult under any circumstances and for a variety of reasons, is especially critical as it regards the connection running between banking risk and the impact of such risk-taking on the macroeconomy. As I have been pointing out, the historic purpose of banks is to take risk through the extension of credit to businesses and households -- credit that is so vital to the growth and stability of the economy. But this fact creates a significant conflict for banking regulators. On the one hand, regulators are concerned with the cost of bank failure to the taxpayer and the impact of such failures on the general safety and soundness of the financial system. On the other hand, banks must take risks in order to finance economic expansion. Decisions about tradeoffs must be made. In the early 1990s, we saw how, in response to FDICIA, new regulations, weakened capital, and large loan losses, banks reduced their willingness to take risks, thereby contributing to a credit crunch and slower economic growth. This recent episode demonstrates clearly how tricky are these tradeoffs between necessary risk taking and protecting the banking system; a swing too far in either direction can create both short-term and long-term difficulties.

A regulator without responsibility for macroeconomic growth and stability tends to have a bias against risk-taking. Such a regulator receives no praise if the economy is functioning well, but is criticized if there are too many bank failures. For such a regulator, the tradeoffs are one-sided and, if the decisions of such a regulator were left unchecked, the result might be a stagnant economy at whose core was a stagnant banking system. In contrast, the Federal Reserve's economic responsibilities are an important reason why we have striven to maintain a consistent bank regulatory policy, one that entails neither excessive tightness nor ease in supervisory posture. The former would lead to credit crunches, the latter, with a lag, would lead to excessive bank failures.

Just as the probability of bank failure should not be the only concern of the effective regulator, bank regulation is not the only, or even the most important, factor that affects the banking business. The condition of the macroeconomy also has something to say about your success as a banker. In that regard, the generally favorable macroeconomic conditions we have been facing for the past few years suggest that bankers should now take pause and reassess the appropriateness of their lending decisions. Mistakes in lending, after all, are not generally made during recessions but when the economic outlook appears benevolent. Recent evidence of thin margins and increased nonbank competition in portions of the syndicated loan market, as well as other indicators, suggest some modest underwriting laxity has a tendency to emerge during good times. This suggests the need for a mild caution that bankers maintain sound underwriting standards and pricing practices in their lending activities.

Toward financial reform without losing the strengths of our current system

Let me now turn from general concerns over our regulatory structure to more specific concerns regarding the supervisory and regulatory treatment of our largest, most complex banking organizations -- a subject in which I suspect community banks have some considerable interest. As the 105th Congress contemplates financial reform legislation, it is critical to focus on the issue of how best to supervise risk-taking in these large entities and, in particular, whether there should be significant umbrella supervision for the entire banking organization.

Historically, bank holding companies have been largely confined to financial activities that are similar to, often the same as, those permissible to commercial banks. Also historically, supervision of banking organizations, both large and small, has tended to focus mainly on the need to protect the bank. To some extent, this emphasis on the bank rather than the nonbank activities of the banking organization was prompted by, or permitted by, management techniques that tended not to treat risk-taking in integrated fashion across the entire holding company. The regulators' main concern was the bank, and bank safety could be analyzed more or less remotely and distinctly from the nonbank activities of the banking organization.

More recently, the focus of supervision of holding companies by the Federal Reserve is being modified to parallel the changes in the management of banking companies. Most large institutions in recent years have moved toward consolidated risk management across all their bank and nonbank activities. Should the Congress permit new nonbanking activities by banking organizations it is likely that these activities too would be managed on a consolidated basis from the point of view of risk-taking, pricing, and profitability analysis. Our regulatory posture must adjust accordingly, to focus on the decision-making process for the total organization. Especially as supervisors focus more on the measurement and management of market, credit, and operating risks, supervisory review of firm-wide processes increasingly will become the appropriate principle underlying our assessment of an organization's safety and soundness.

Some market participants -- especially nonbanks contemplating buying banks in the wake of any new Congressional legislation, as well as banks contemplating entering newly permissible nonbank activities -- are naturally concerned over the thought of bank-like regulation being extended to their nonbank activities. We share this concern, and last month we asked Congress to modify our mandate to permit the Fed to be more flexible on such issues as applications for new activities. At the same time, however, we believe there has been some considerable misunderstanding of our basic philosophy of holding company supervision. The focus of the Fed's inspections of nonbank activities of bank holding companies is to gain a sense of the overall strength of the individual units and their interrelations with each other and the bank. As I indicated above, emphasis is placed on the adequacy of risk management and internal control systems. Only if there is a major deficiency in these areas would we intend for a bank holding company inspection to become in any significant way "intrusive," and the number of such intrusive inspections of nonbanking activities should be quite small if managements are following prudent business practices.

Some observers have questioned not only the need for umbrella supervision, but also the need for the Fed's involvement in such supervision. In addition to the reasons I cited above for central bank involvement in supervision, there is the issue of systemic risk and the fact that it is primarily the Federal Reserve's obligation to maintain stability in our financial system and that system's interface with international financial markets. This obligation cannot be met solely via open market operations and use of the discount window, as powerful as these tools may be. Financial crises, when they occur, are unpredictable and diverse in nature. Globalization means that a domestic crisis can become international or that a foreign crisis can become a domestic concern. The Federal Reserve's ability to respond quickly and effectively to any particular systemic threat rests primarily on our experience and expertise with the details of the U.S. and foreign banking and financial systems, including our familiarity with the payments and settlement system. This expertise, in turn, has been accumulated over the years primarily through our supervision of large domestic and multinational banking companies, and via our participation in large payments and settlement systems which are such a critical part of our financial infrastructure.

In order to carry out our responsibility, the Fed must be directly involved in the supervision of banks of all sizes -- such as now provided by member banks -- and must also be able to address the problems of large banking companies if one or more of their activities endanger the stability of our financial system. This implies that the Federal Reserve have appropriate supervisory authority. Moreover, the new regulatory structure must retain our flexibility to respond to changes in the structure of the financial system, especially where such changes cannot easily be forecast in the wake of significant legislative changes. Systemic crises occur very rarely by their very definition. But when such crises do occur the consequences of slow or misdirected action are grave. The central bank, as the lender of last resort, must have the knowledge, the tools, and the authority necessary to act in a timely and decisive fashion. This is necessary to protect the whole financial system, not the least of which are the critical players among our community banks.

Conclusions

Let me conclude by reiterating two of the Federal Reserve's most basic concerns as the current Congress deliberates the issue of financial reform. First, we should recognize the increasingly evident fact that financial firms of all sorts now engage routinely in a wide variety of financial activities that, just a few decades ago, were considered to be nontraditional. Even in cases where the financial activity is currently not permitted directly, the risks and returns of the activity can be mimicked through the prudent use of financial derivative instruments such as put and call options. We should recognize these facts and, in response, structure legislation that would permit the full economic integration of these various forms of financial activity, in order to gain the maximum operating efficiencies, the best tradeoffs between risk and return, and the most flexibility in meeting the needs of the customer. But new legislation should not attempt to accomplish too much too soon. The Board believes it is prudent to delay, or to implement in stages, broad authorization of nonfinancial activities for banking companies. We want to be sure of the smooth functioning of integrated financial activity before we address potential combinations of banking and commerce.

Second, in permitting broadened financial powers, legislation should strive to maintain the current roles of both the dual banking system and the central bank. Financial reform should not be interpreted to mean regulatory reform for its own sake. Banks of all sizes must have their regulatory choices preserved, just as financial firms of all sizes should be permitted to engage prudently in a wide range of financial activity. Finally, the central bank must continue to be able to monitor and address activities of large banking organizations that might threaten the stability of the system. I am confident that prudent, reasoned financial reform can be accomplished in a manner that preserves the best of the current system while introducing the improvements that we all desire.