Mr. Greenspan discusses financial reform and the importance of the State Charter Remarks by the Chairman of the Board of Governors of the US Federal Reserve System, Mr. Alan Greenspan, at the annual meeting and Conference of State Bank Supervisors held in San Diego, California on 3/5/97.

I am pleased once again to address this annual meeting of the Conference of State Bank Supervisors. Before I begin, I would like to join his colleagues in wishing Bob Richard well. Over the years, it has been a pleasure to work with him. He will be sorely missed.

Today, I shall concentrate my remarks on the current debate in Congress and elsewhere on how best to accomplish financial reform. This subject has been a recurring theme in Federal Reserve comments, speeches, and testimonies during the first part of 1997 and, I suspect, the subject will continue to engage us for some months ahead. My remarks today will reemphasize some of the points made at other venues this year, although I will attempt to place these arguments in the context of the impact of financial reform on the state-chartered banks and on the roles such banks, and their regulators, play in maintaining the overall well-being of our banking system and our economy.

To begin, there does appear to be general agreement on the need for financial reform. Permitting various financial businesses to be conducted jointly should provide the benefits of increased services and/or lower prices to financial customers, improved risk reduction, and cost savings for financial firms. More broadly, it should improve the efficiency and stability of the financial system that underlies our economy. These benefits are expected to flow primarily from opportunities for diversification, non-interest cost reduction, and cross-marketing for those banks, investment banks, and insurance companies that find ways to profitably merge their businesses in the wake of legislation permitting expanded powers for banking organizations.

But the longer financial reform is delayed, the less important and useful it will be. Put in economist's jargon, the longer the delay the lower the marginal economic benefits produced by reform legislation, and the more we should be concerned instead with possible unintended negative effects that might outweigh those marginal benefits. Let me explain.

Financial markets, as we all should know by now, have a way of effectively circumventing uneconomic barriers or bottlenecks created by inefficient legislation or regulation. Today, it has become possible, through the judicious use of derivative instruments, for a financial firm engaged primarily in one kind of financial activity to mimic the risks and returns of any other financial activity. Banking, investment banking, and insurance can no longer be viewed, from a risk-return perspective, as separate and distinct lines of business. To cite just one example, banks are prohibited from underwriting insurance, yet the writing of a put option -- a form of derivative activity engaged in widely by large banks -- is, in economic substance, a form of insurance underwriting. Other derivative markets, including the emerging credit derivative instruments, now permit banks to diversify their credit and market risks as if they had been permitted to merge with investment banks or insurance companies. Thus, some of the long-sought-after economic benefits resulting from the repeal of legislative barriers between and among different "types" of financial firm already have been achieved through the creativity of the marketplace. Nevertheless, by not being able to engage directly in the impermissible activity, a banking company cannot achieve the production or marketing synergies, and therefore the cost reductions, that may flow from joint operations and that may benefit a bank's shareholders as well as its customers.

In addition to the actions of the marketplace, banking regulators have acted, within the constraints of statute, to facilitate economic combinations of banking and nonbanking financial activities. Specifically, the Federal Reserve has adopted both liberalization of Section 20 activities and expedited procedures for processing applications under Regulation Y. The OCC, meanwhile, has

generated some controversy by liberalizing banks' insurance agency powers as well as procedures generally for establishing operating subsidiaries of national banks that may engage in activities not permitted to the bank.

This is not to say that financial reform legislation will have no marginal benefit. Clearly, in addition to the benefit of lowered costs, much remains to be accomplished in the form of improved management efficiency. These benefits, which will accrue both to the banks and the general public, probably can be maximized only within the context of clear legislative authority for combining financial firms of various types. We must be careful, however, in our efforts to achieve the benefits of financial reform, not to violate the tenets of good public policy. In this regard, the Federal Reserve believes that any financial reform 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 federal safety net. I have spent a good deal of time of late on the fourth objective. Therefore, today I will concentrate on the first three and how, in particular, financial reform must be careful to preserve the role of the state-chartered bank in meeting our economy's macroeconomic objectives and our concerns regarding systemic risk.

The importance of the state-chartered bank

Some erroneously dismiss state-chartered banks as representing only the down-scale end of the banking market and, therefore, being not particularly worthy of careful policy consideration. State-chartered banks indeed are smaller on average than national banks, and are disproportionately represented within the very smallest size class. Nevertheless, state-chartered banks account for about a third of our superregionals, not to mention a few state banks that are among the very largest money center institutions. Even the preponderance of small, state-chartered banks, however, play a critical role within our financial system, for several reasons.

First, having large numbers of community-sized banks, be they state-chartered or national banks, is a major contribution to the stability of the banking system and the well-being of the macroeconomy. Just as a more highly diversified loan portfolio reduces risk to the individual bank, a more highly diversified banking structure reduces risk to the banking system as a whole. Indeed, our decentralized and diverse banking structure was arguably the key to weathering the financial crisis of the late 1980s. During those dark days, our system was able to absorb more than a thousand U.S. bank failures. And yet here we are, less than a decade later, with loan loss reserves and bank capital at their highest levels in almost a half century, and the insurance fund restored to its maximum coverage ratio -- all without cost to the taxpayer. Of course, the bank failures of the past decade, combined with the current wave of mergers and acquisitions, have served to reduce significantly the total number of banking organizations in the U.S. But the more than 7,000 separate banking companies that remain are more than sufficient to maintain our highly decentralized and flexible banking structure.

Large numbers of small banks go hand in hand with a macroeconomy characterized by large numbers of small, entrepreneurial nonfinancial businesses. Smaller banks traditionally have been a major source of capital for small businesses that may not have access to securities markets. In turn, small businesses account for the major portion of new employment and new ideas, thereby playing a major role in fueling economic growth.

This connection running between small banks, small business, and the macroeconomy -- indeed the role of banks generally in funding business expansion -- is so important that we must be sensitive to the tradeoff between risk-taking and bank solvency. Risk-taking -- prudent risk-taking to be sure -- is the primary economic function of banking. All wealth is measured by its perceived ability to produce goods and services of value in the future. Since the future is fundamentally

unknown, endeavoring to create wealth implies an uncertain expectation of how the future will unfold. That is, creating wealth is risky.

Hence banking, to further its primary economic purpose of financing the economy, cannot and should not avoid prudent risk-taking. Bank supervisors, in turn, need to recognize that the optimal bank failure rate is not zero. A zero failure rate over time implies either extraordinary insight by bankers, a notion I readily dismiss, or an undue and unhelpful degree of conservatism in banking practice. In taking on risk, of course, some mistakes will be made, and some banks will fail. Even if a bank is well-managed, it can simply become unlucky. Failure should occur, indeed does occur, as part of the natural process within our competitive economy. It should not be viewed as a flaw in our financial system, and certainly we should not attempt to eliminate it. Only when the failure rate threatens to breach a prudent threshold should we become concerned.

Just as large numbers of smaller banks are a key to the robustness of our economy, the state charter is a key to the robustness of our banking structure. The dual banking system has fostered a steady stream of banking innovations that have benefited consumers and bank shareholders alike. For example, the NOW account, as I like to point out, was invented at a state-chartered bank; and the NOW account was the opening shot in the campaign to remove national deposit interest rate controls and allow banks to compete on common ground with nonbank institutions such as money funds. The 1994 interstate branching statute likewise has its origin in the state laws that permitted cross-border banking, beginning with the rewriting of the Maine banking laws. Adjustable rate mortgages are another innovation that began at the state level, and of course, the National Banking Act itself has its origin in the states' "free banking" laws of the nineteenth century.

The dual banking system not only fosters and preserves innovation but also constitutes our main protection against overly zealous and rigid federal regulation and supervision. A bank must have a choice of more than one federal regulator, must be permitted to change charters, to protect itself against arbitrary and capricious regulatory behavior. Naturally, some observers are concerned that two or more federal agencies will engage in a "competition in laxity", and we must guard against that; but the greater danger, I believe, is that a single federal regulator would become rigid and insensitive to the needs of the marketplace. Thus, so long as we have a federal guarantee of deposits, Federal Reserve guarantee of intraday payments over Fedwire, and other elements of the safety net -- and, therefore, so long as there is a need for federal regulation of banks -- such regulation should entail a choice of that regulator at the federal level.

As you are well aware, the Federal Reserve has long been a strong supporter of the dual banking system in the context of efficient supervision. That is why we, along with the FDIC, have sought examination partnerships with the state banking regulators. Currently, the Fed has cooperative agreements with about three dozen states, calling for either joint examinations or alternate year exams. Overall, our experience with these programs has been quite positive, in part because of the quality of state supervision in the states with the cooperative agreements. Indeed, the evidence suggests that safety and soundness of state banks compare quite favorably with national banks, possibly reflecting the benefits of having both state and federal supervision. For example, during the banking crisis of the late 1980s, when the failure rate by any measure breached the prudent threshold I mentioned earlier, the national bank failure rate was considerably greater than for state banks. While bank failure is determined by more than just the supervision process, these data nevertheless speak well of the quality of the state supervisory process and the ability of the state and federal regulators to function together efficiently.

The dual banking system, however, despite its advantages and achievements, is under attack. This attack is neither particularly intentional nor particularly coordinated, but rather consists of the unintended consequences of statutory and regulatory changes aimed at achieving broader policy objectives. I am referring primarily to the consequences of the 1994 interstate branching

legislation, coupled with the OCC's recent liberalization of regulatory procedures for operating subsidiaries of national banks. These events may have served to tip the balance in favor of national banks, so to speak, in a manner that weakens banks' ability to switch federal regulators without incurring prohibitive real economic costs. In particular, while most state-chartered banks will continue to operate on an intrastate basis in local markets, regional and nationwide banks may find that state charters are burdensome to the extent that the banks are forced to operate under varying regulatory rules and procedures across multiple states. If that burden were to become excessive, banks with interstate operations -- especially interstate retail operations -- would likely turn to the national charter on grounds of simple expediency. For example, I am struck by the fact that the very largest state-chartered banks among the money center institutions are without significant retail operations or without announced intentions to expand retail banking beyond their home states. The rest of the large state-chartered banks, those with assets over $10 billion, consist mainly of lead banks in multi-bank, multi-state holding companies. It seems likely that some of these institutions will seek to consolidate their interstate retail operations under a national bank charter after interstate branching becomes fully operational, unless countervailing forces emerge.

The evident superiority of the national charter is not a foregone conclusion, however. For example, the Federal Reserve this past month approved an application by a superregional banking company to consolidate its retail branches in four states under a single state-chartered bank headquartered in Alabama. The consolidation would become effective on or after June 1, 1997, when the Riegle-Neal Interstate Banking Act becomes operational. Another positive indication of the resiliency of the state charter has been the establishment of the State-Federal Working Group. This cooperative effort involving the states, the CSBS, the Federal Reserve, and the FDIC is contributing importantly to the strengthening of the supervision of state-chartered institutions through a number of initiatives, including the adoption of the State/Federal Protocol. The Protocol and the Nationwide Supervisory Agreement of 1996 spell out the principles and specific actions that would lead to a seamless supervision and examination of interstate, state-chartered banks. Other initiatives of the State-Federal Working Group include greater examination emphasis on bank risk management processes, a more formalized, risk-focused approach to examination, and expanded and more effective use of information technology. It would also be extremely helpful, especially if enacted prior to interstate branching becoming fully operational, if the Congress were to pass the so-called home state rule, which would place state-chartered banks on an equal footing with national banks with regard to permissible activities of branches in a host state.

Systemic Risk and the Role of the Federal Reserve

By now, we are all acutely aware that the process of "financial reform" is a complex one, with intended and unintended consequences flowing from almost every act of the legislator or regulator. I have focused today on only two aspects of the debate over financial reform, albeit two very important aspects -- the need to maintain our uniquely decentralized banking system, with its reliance on large numbers of relatively small institutions, and the desirability of retaining the dual banking system, with its implicit choice of regulator. Let me conclude by turning to another important facet of the debate over financial reform -- the role of the Federal Reserve in containing systemic risk. It is critical that we guard against diminution of this role as yet another unintended consequence of financial reform.

The risk of systemwide disruptions, for better or for worse, is importantly determined by the actions or inactions of our largest, most complex banking organizations. The architects of financial reform, therefore, must necessarily consider how best to supervise risk-taking at these large organizations and, in particular, whether there should be significant umbrella or consolidated supervision of the banking company.

In the past, holding company supervision was concentrated at the bank level, not only because the bank tended to constitute the bulk of risk-taking activities but also because the holding company tended to manage the bank separately from the various nonbank activities of the organization. More recently, however, the focus of supervision of holding companies by the Federal Reserve has been modified to reflect changes in management procedures -- holding companies now tend to manage risk on a consolidated basis across all their bank and nonbank subsidiaries. Risk and profitability measurements, including, for example, risk-adjusted return on capital calculations, most often are made by business line rather than on a subsidiary basis. As banks engage in new or expanded nonbanking activity in the wake of financial reform, it is likely that these activities too would be managed on a consolidated basis. For this reason, and because supervisors recognize that scarce examination resources are often most effectively employed by focusing on risk management processes, our determination of an institution's safety and soundness increasingly will be based on an analysis of the decisionmaking and internal control processes for the total organization.

Such umbrella supervision need not be in any significant way "intrusive", nor should financial firms be burdened by the extension of bank-like regulation and supervision to their nonbank activities. For some time, the focus of the Fed's inspections of nonbanking activities of bank holding companies has been to assess the strengths of the individual units and their interrelations with one another and with the bank. Emphasis is placed on the adequacy of risk measurement and managements systems, as well as internal control systems, and only if there is a major deficiency in these areas should the inspection of the nonbank activities become at all intrusive. We intend that this philosophy of holding company supervision will not change as banks are granted extended powers.

Finally, I should note that some have questioned not only the need for umbrella supervision but also the need for the Fed's involvement in such supervision. It is primarily the responsibility of the Federal Reserve to maintain the stability of our overall financial system, including the interconnections between the domestic financial system and world financial markets. This obligation to protect against systemic disruptions cannot be met solely via open market operations and use of the discount window, as powerful as these tools may be.

If the past is any guide, financial crises of the future will be unpredictable and unique in nature. The globalization of financial and real markets means that a foreign crisis can impact on the domestic financial system, and vice versa. Our ability to respond quickly and decisively to any systemic threat depends critically on the experience and expertise of the central bank with regard to the institutional detail of the U.S. and foreign financial systems, including our familiarity with payments and settlement systems. Thus, in order to carry out our systemic obligation, the Federal Reserve must be directly involved in the supervision of banks of all sizes and must, in particular, be able to address the problems of large banking companies if one or more of their activities constitute a threat to the stability of the financial system.

Conclusions

The concerns I have outlined today demonstrate the necessity that the central bank maintain appropriate supervisory authority and, as I hope I have made clear, this authority is best exercised within the current context of the dual banking system, a system that has served us so well over the generations. Financial reform clearly is needed, but financial reform should not be interpreted to mean regulatory reform for its own sake. I am hopeful that reasoned financial reform, based on sound tenets of public policy, can be achieved in a manner that preserves the best components of the current system while introducing the improvements that are long overdue.