Alan Greenspan: Banking

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, at the American Bankers Association Annual Convention, New York, 5 October 2004.

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It is a pleasure to join you once again at the annual convention of the American Bankers Association. By any measure, banking in the United States today is strong, vibrant, and profitable. However, a number of times in the past half-century, many informed observers questioned the long-term viability of commercial banking. U.S. commercial banks, which began the post-World War II period as the dominant financial institution, soon faced intense competition from thrifts, from new forms of mutual funds, from customer direct financing in the securities markets, from foreign banks, and from a wide range of nondepository lenders. As the competition intensified, banks found their ability to respond increasingly constrained by rules and regulations established in the far different environment of the Great Depression of the 1930s. And banking, just like other businesses, faced the implications of immense changes in technology and of the rapid growth in globalization, which created new risks as well as new opportunities. Under the circumstances, the present health of banking is a dramatic testament to both the management skills of bankers and the ability of regulators and legislators to adapt, albeit slowly, to change.

This morning, I would like to review some of the major innovations and changes that have propelled banks to their present state and have allowed them successfully to navigate through a rapidly changing economic and technical environment.

A further word of prologue, however, is necessary to understand today's banking markets. What turned out to be bad credit judgments, especially in real estate, energy, and foreign credit markets, coupled with high interest rates and a deep recession, led to the assisted acquisitions of almost 120 banks and the actual demise of about 1,250 of them between 1985 and 1992. Many more had a near-death experience, and survivors recapitalized by raising $176 billion of new long-term capital, including $13 billion of equity, from 1991 to 1995. The managers of these surviving organizations had deeply impressed upon them anew the need to manage risks, to control costs, to build capital and reserves, and generally to focus on the lessons of banking history. The passage of time no doubt has caused the experience to fade for those banks that looked into an abyss, but survived; nevertheless the systems and procedures that were put into place by many institutions remains one of the hallmarks of today's banking industry.

To fund or not to fund

The first response to the changing environment after World War II occurred in the early 1960s, with banks' decision to actively compete on a price basis to buy money to fund operations - the development of the negotiable certificate of deposit (CD). For years preceding the 1960s, banks had no reason to aggressively seek deposits. During the Great Depression, credit demands on banks, of course, were unusually low, and during and immediately after World War II banks were extremely liquid owing to heavy accumulations of U.S. government securities, an aftermath of war-time financing. The decision to compete on a price basis using instruments such as the negotiable CD seems quaint today, but in the early 1960s it represented a sea change in the way managers thought about the business of banking. And its implications turned out to be far reaching. It was a modest step forward to the whole range of nondeposit and price-sensitive borrowing, from the repurchase agreement to the subordinated debenture, not to mention the NOW account and the range of retail time deposits that banks routinely tap by adjusting offering rates when additional funding is needed. Many of these instruments, including the large-denomination, market-rate-based deposit, that was once thought to be only for large banks, are now used, with great success, by community banks when their core deposits fall short of their funding needs.

Indeed, banks of all sizes will never again be the passive deposit takers that they were at the beginning of the 1960s. To be sure, the whole range of services and characteristics of bank claims are important, but banks now both can and do look at the cheapest source first and pay at the margin what is necessary to obtain the needed funding.

When deposit rate ceilings - Regulation Q - first constrained the ability of banks to pay the market rate on CDs in the mid-1960s, banks shifted to a source that was then unconstrained, the Eurodollar market. This step not only underlined the increasing importance of globalization but also finally required legislators and regulators to consider the efficacy and policy implications of deposit rate ceilings. Only the inability of thrifts to sustain deposit inflows with the high rates of the mid-1960s and the late 1970s, an important cause of the later thrift crisis, kept the eroding deposit rate ceilings from being eliminated until the 1980s. But the principle slowly began to be established that regulations that are inconsistent with market realities cannot be sustained indefinitely, although vestiges may remain long beyond the regulations' perceived usefulness.

The pricing of liabilities was not the only response of banks to the new competition. Another was the securitization of consumer and residential mortgage loans - the conversion of a pool of credits into a security - that others not necessarily other banks, could hold. Securitization also allowed the creating bank to remove the underlying loans from its books. The bank, or an affiliate, might provide limited recourse or take an equity position in the pool to provide a credit enhancement, but the concept was clearly to eliminate the need for funding while profiting from fees or rate spread. The syndicated commercial loan soon followed the initial securitizations, with the managing bank acting more like the lead underwriter on behalf of a syndicate, a syndicate that, I might add, increasingly is composed of nonbank financial institutions.

Some observers at the time, projecting these developments, concluded that the bank of the future would hold virtually no assets, would require virtually no funding, and would have no branches. The vision that the bank of the future would be essentially an underwriter of diverse credits has not come to pass, despite the continued growth of securitization and syndication, because taking credit risk, the historic core of banking, remains profitable for those that know how to manage it effectively. In addition, with better pricing, deposits have been restored as a more-resilient funding source. Moreover, the market test has clearly underlined the customer desire for branches at most types of banking organizations.

Pricing and managing risk

One of the more painful lessons learned in the 1970s and 1980s is that accepting narrow or nonexistent spreads in order to retain market share is a losing strategy. This lesson seems clear enough, but many banks were nevertheless reluctant to see traditional customers shift to other markets, let alone other banks, and matched loan rates despite the resultant lackluster returns on equity. Competition in the loan market can still be intense, as it is today. Nonetheless, even with narrowing margins most recently, loan pricing is now generally linked to careful assessment of economic returns that often includes an assessment of the profitability of the credit and the overall relationship.

Loan officers, if left to their own devices, might be more interested in booking loans than in evaluating risk and pricing loans commensurately. But, pricing, credit decisions, and risk measurement and management at those banking organizations displaying best practices have increasingly been based on systems and procedures that impose a quantifiable discipline. That discipline, in turn, has given the credit-risk manager the ability to make the case for absolute and relative risk, enabling the bank to *choose* its risk profile rather than having it imposed by events. Quantification of risk has contributed to a changing balance of power between loan officers and credit-risk managers.

We have already begun to see the benefits of this new balance. The tightening of lending standards by banks has historically occurred at, or most often after, cyclical peaks, accentuating the decline in economic activity. Before our most recent recession, however, banks began to be more selective lenders in response to the data indicating cumulating deterioration in borrower balance sheets. The volatility of interest rates in 1998 associated with the Asian crisis and the Russian default, as well as cautions from the regulatory community, also provided a useful early warning, and the memory of the painful losses of the late 1980s and early 1990s contributed importantly to the response of bank management. But, in my judgment, better risk measurement and risk management were noticeably important in moderating overall credit losses during the most recent recession and in establishing the higher credit standards that have been so important in the most recent years.

The supervisory authorities are seeking, as you know, to build on these best practices of banks in developing the new capital rules, Basel II. The improving bank practices, coupled with the new rules, hold out the hope of a safer and stronger banking system contributing to a more stable economy. We anticipate that the best practices and procedures will spread beyond the largest banks, even to those entities that are not required to adopt the new capital rules.

No discussion of better risk management would be complete without mentioning derivatives and the technologies that spawned them and so many other changes in banking and finance. Derivatives have permitted financial risks to be unbundled in ways that have facilitated both their measurement and their management. Because risks *can* be unbundled, individual financial instruments can now be analyzed in terms of their common underlying risk factors, and risks can be managed on a portfolio basis. Concentrations of risk are more readily identified, and when such concentrations exceed the risk appetites of intermediaries, derivatives and other credit and interest rate risk instruments can be employed to transfer the underlying risks to other entities. As a result, not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient.

Derivatives have been used effectively by many banks to shift interest rate risks. In addition, while credit risks are transferred among financial intermediaries based on their ability and willingness to absorb such risk, increasingly credit risk has been transferred from highly leveraged financial institutions to those with much larger equity coverage. For example, not only has a significant part of the credit risks of an admittedly few large U.S. banks been shifted to other U.S. and foreign banks and to insurance and reinsurance firms here and abroad, but such risks also have been shifted to pension funds, to hedge funds, and to other organizations with diffuse long-term liabilities or no liabilities at all. Most of the credit-risk transfers were made early in the credit-granting process; but in the late 1990s and early in this decade, significant exposures to telecommunication firms were laid off through credit default swaps, collateralized debt obligations, and other financial instruments. Other risk transfers reflected later sales at discount prices as specific credits became riskier and banks rebalanced their portfolios. Some of these sales were at substantial concessions to entice buyers to accept substantial risk. Whether done as part of the original credit decision or in response to changing conditions, these transactions represent a new paradigm of active credit management and are a major part of the explanation of the banking system's strength during the most recent period of stress. Even the largest corporate defaults in history (WorldCom and Enron) and the largest sovereign default in history (Argentina) have not significantly impaired the capital of any major U.S. financial intermediary.

Technology

Technology, as I have noted, has been among the most significant factors permitting banks to adjust to the new competitive environment in making credit decisions, in measuring and managing risk, and in creating and using new instruments. Technology of course, is a two-edged sword. The technology that banks use so profitably in risk measurement and management and in their dealing and underwriting activities is the same that their rivals and their customers used to deprive banks of the traditional lending business with their best customers. However, technology has also allowed banks to assess the credit and other risks of customers previously deemed too risky and, then, to extend credit profitably to such borrowers.

Some investment in bank technology has been largely defensive, with the gains captured mainly by customers who would otherwise have shifted to competing institutions. Retail internet banking and, for some smaller banks, ATMs, are examples. But the use of even these defensive investments has often yielded benefits for banks from greater fees and from lower costs resulting from reduced check processing.

I would be remiss not to note the more-direct contributions of technology to increased productivity in banking, the same kind of improvements that have occurred throughout our economy. Such gains are notoriously hard to measure in banking, but have visibly contributed to the improved profitability of banking. Not all such gains have been cost reducing: Some have increased cost, but have raised revenue even more by improving the variety and quality of banking services in ways for which customers are willing to pay. The increase in banks' fee income is not unrelated to improvements in technology.

Bank consolidation

Technology has also facilitated consolidation in banking by making it more efficient at the margin - or perhaps less inefficient - for firms to become larger, more geographically dispersed, and better able to manage multiple business lines. Research at the Federal Reserve and elsewhere is consistent with other indications in the past decade or so of cost scale economies, or fewer diseconomies, and improved control by multibank holding companies over their bank subsidiaries. Improvement in the ability of these organizations to make small business loans over a wider geographical area is striking. Some of the consolidation of the past decade would not have been possible if the Congress, led by the states, had not removed prohibitions on interstate banking and branching. The combination of the resultant geographical diversification with the product line diversification facilitated by technology and the removal of out-dated legal prohibitions, has, in my view, greatly strengthened the stability of our financial system. Diversified banking organizations in most recent years have been able to absorb substantial losses in some lines or weak demand for some products without significant hits to capital or, in some cases, even to earnings. Banking history as recently as the 1980s and early 1990s would have been quite different had our banking structure then been more similar to that of today.

The recent consolidation of the banking system has been dramatic. Excluding intra-bank holding company mergers, and including the approximate 100 announced but not yet completed mergers, about 2,400 banking organizations have been absorbed by other banking entities since 1995. If all the mergers that have been announced are completed, the ten largest banking organizations in the United States will account for about 51 percent of all domestic banking assets, almost double their share in 1995. Consolidation has not been a phenomenon involving only large banks. Roughly 45 percent of the mergers involved an acquirer *and* a target each of which had less than one billion dollars in assets. I must emphasize that, despite these merger trends, market and other pressures have kept measures of *local* market banking concentration virtually unchanged. An important factor has been the almost 1,400 new commercial bank formations since 1995.

It would be a mistake to conclude from these comments that the only way to succeed in banking is through ever-greater size and diversity. Indeed, better risk management may be the only truly necessary element of success in banking. The variety in scale, strategy, and approach among quite profitable and well-capitalized banks in this country is striking. A handful of organizations operate diversified, multi-line, financial service businesses nationally or globally or both. Others deliver services throughout a multistate region. Some specialize in credit cards or mortgage finance. Some operate an alliance of smaller, independent organizations through multibank holding companies, seeking local investors and management. Some insurance, securities, or investment management firms have become affiliated with banks with the intention of broadening their product lines. Some banks have large branch systems whereas others have business plans with no branches, using mail and ATMs as alternatives. A very few are trying to operate without brick and mortar, only through the Internet. And, by number, our structure is still dominated, as it will continue to be, by the community banks that offer local services through local management, using specialized local information. The potential for new entrants, we should not forget, is always there and will keep the existing entities on this non-exhaustive list on their toes.

Conclusion

The factors that have contributed to the strength, resilience, and profitability of the U.S. banking system, which I have described, should continue to guide the industry in the years ahead. We have, in short, every reason to believe that banks of all sizes and types will continue to successfully compete in an ever-changing market environment. Nonetheless, as time passes, more and more bank managers will not have the first-hand memories of times of banking stress. That is why we must endeavor to build into bank and regulatory systems the product of the earlier experiences in order not only to retain and consolidate the gains made, but also to rapidly incorporate more widely the future advances that best-practice banks will continue to make.