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An address by

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It's a particular pleasure to have this opportunity to once again address the A.B.A. Annual Convention.

I have had the good fortune to be associated with banking for over 15 years -- as a lawyer representing banks throughout Wisconsin, as a banker in Kentucky and as a member of the board of the FDIC. This period, particularly the past five years, has been filled with change and challenge.

Since this may well be my last appearance before this group as Chairman of the FDIC, there are many thoughts I would like to share with you.

The first is to express deep appreciation for the overwhelming support you and your Association have given me and the agency I have been privileged to lead. We have not always agreed on every issue, but we have always shared a common goal: the maintenance of a strong banking system that is fully responsive to the needs of the American public.

The second is to commend you for the manner in which you have guided your banks through one of the most difficult periods in history. The economic environment has been harsh. More than a decade of accelerating inflation was followed by extremely high and volatile interest rates and two back-to-back recessions. As if that were not enough, you have also had to cope with deregulation of your liability costs, rapidly changing technology, the emergence of major new competitors and the failure of Congress to provide even the slightest relief by permitting you to offer a broader array of financial services to the American public. To your great credit, the banking system remains strong and secure.

We often hear about what is wrong in banking today. There are nearly 800 banks on the problem list, more than twice the previous record. Earnings are under pressure due to higher interest expenses and loan losses. The failure rate during the past three years has been much higher than in any period since the 1930s. There is plenty of negative news to dwell upon.

I prefer to focus on what is right with banking. Despite the economic and competitive environments and the failure of Congress to give you the tools you need, 85 percent of all banks are in good condition. Earnings are under pressure, but last year the banking industry earned $15 billion, up slightly from 1982, making it the third most profitable industry in the nation in terms of total earnings. Banking's aggregate capital ratio has increased for four successive years, and its loan loss reserve ratio has increased for six successive years. The failure rate is high, but, at less than one-half of one percent per year, it remains well below any other industry with which I am familiar and far lower than was typical even in banking prior to the 1930s.

Moreover, banking has established and borne the cost of the most effective safety net in the world. After absorbing record losses during the past four years, and without relying on one nickel of taxpayer money, the FDIC insurance fund is stronger and more liquid than ever.

I do not want to inundate you with statistics, but let me cite a few to illustrate the strength of the deposit insurance system. During the first 47 years of the FDIC, the agency handled 568 bank failures with $9 billion in assets. Since the beginning of 1981, the FDIC has handled 165 failures with $27 billion in assets, excluding Continental. Continental alone was larger than the combined total of all bank failures in the history of the FDIC. Our losses in 1981 and each year since have been in the range of $1 billion annually, compared to less than $500 million during the first 47 years combined. What has happened to the FDIC fund? Remarkably, it has grown by over 50 percent, from $11 billion to nearly $17 billion. This year our gross income will be in the range of $3 billion and our net cash flow will exceed $5 billion.

Are there problems in banking? Of course there are. How could we expect otherwise in view of the environment in which banks have been forced to operate? But there is no question that the system's weaknesses pale in comparison to its strengths.

Third, I want to share with you some insights into the manner in which we are managing the FDIC in this era of change. Only a short time ago, the FDIC was a largely anonymous agency supervising primarily small banks and dealing with a handful of small failures each year. The environment in which the agency now operates, like the one into which you have been thrust, could not be more different. As you doubtless have been doing, we have been scrambling to stay abreast of developments.

Banking today is a more complex, faster-paced business in which to compete. It is also a much more difficult business to properly supervise. There are many more ways for a bank to get into difficulty, and it can happen virtually overnight.

Just as you need more skilled personnel to cope with the complexities of your business, so do we. We are currently spending $6 million per year on training. Just as you need more and better information about your business, so do we. We have made a major commitment to upgrading the quality of our off-site monitoring and analysis of banks. Just as you need to focus your scarce human resources where they are most needed, so do we. We are targeting our supervisory efforts in those areas where our exposure is greatest: larger institutions and troubled banks, irrespective of their charter. Just as you need to provide better, more efficient service, so do we. We have completely overhauled our applications procedures to eliminate most of the paperwork and speed the processing. For example, our branch application has been reduced from a lengthy form requiring voluminous data to a simple, one-page letter, and the processing time has been shortened during the past year from an average of 78 days to only 18 days for a sound bank. Just as you need to control costs, so do we. The FDIC's operating expenses were up 4.5 percent in 1983 following an increase of only 2.1 percent the previous year. Just as you need to invest sensibly in technology, so do we. For example, the FDIC has committed over $9 million in a three-year project to automate our burgeoning liquidation activities.

In short, our challenges and problems are pretty much the same as yours. Our goal is to be as effective and efficient as possible. We want to get out of the hair of well-run banks and move swiftly and forcefully against the small minority of poorly managed banks. In that regard, the FDIC initiated 272 formal enforcement actions last year, more than a fivefold increase over 1980.

The final thoughts I want to share with you concern the future. The regulatory framework governing banking is now over 50 years old and, in some fundamental ways, is hopelessly out of date.

The first issue involves the severe limitations placed on the ability of banks to compete and serve the financial needs of the American public. As an insurer responsible for maintaining strength and stability in an industry trying to cope with liability deregulation and facing enormous competitive pressures from Sears, Merrill Lynch, American Express, Prudential and other largely unregulated financial conglomerates, I am deeply concerned about the inability of Congress -- despite the efforts of Senator Garn and others -- to rectify these obvious inequities. As a consumer who desires convenient access to financial services at the best price, I am offended by the special-interest politics that deny me the fruits of competition.

Myths abound regarding the alleged risks in allowing banks into such fields as insurance, real estate and securities. Does anyone seriously believe that acting as an agent or broker in these areas involves more than a fraction of the risk bankers face each day? Can anyone demonstrate that life insurance underwriting is significantly different from the banking business, apart from the fact that it is less regulated? Is there materially greater risk in underwriting revenue bonds than general obligation bonds? Is it appropriate for the nation's largest life insurance company to acquire a major investment banking firm while similar affiliations are denied to banks? Would the failure of a major life insurer cause less disruption and hardship than the failure of a major bank?

The answer to each question is a resounding "no." But not very many people are interested in the facts. At its core, the issue of "bank powers" involves a different kind of power: political power.

Banking is represented by a multiplicity of trade groups that are sending conflicting and confusing signals. The insurance and securities industries have no doubt about what they desire -- they want to keep banks off their turf while they exploit loophole after loophole to enter the banking business. Even if the banking industry were united and aggressive in its pursuit of competitive equity, it would nevertheless be the clear underdog. Do you realize that there are more independent insurance agents in New Jersey than there are banks in the entire country? If banking remains divided, it will lose the battle by default, and it, together with consumers and businesses throughout the nation, will pay the price for years to come.

The second issue concerns our regulatory system. Put bluntly, the current regulatory system, with five federal agencies regulating and insuring banks and thrifts, is inefficient and inequitable. It is no longer possible to rationalize a system in which bank holding companies are supervised by one agency while the banks controlled by them are supervised by one or more different agencies. Nor can we justify a system in which savings and loan associations, which are in direct competition with banks for deposits and many loans, operate under vastly more lenient capital, disclosure and accounting standards. Nor can we tolerate much longer a system in which a tangled web of state and federal agencies are responsible for the various segments of related banking enterprises, as in the case of the Butcher empire and its seven different supervisory agencies.

The agencies have tried to make some sense out of the current structure. Particularly noteworthy are the cooperative examination program between the FDIC and the Comptroller of the Currency and the greatly enhanced communications between the two agencies. But all the tinkering in the world is not going to fix a system that is so fundamentally flawed.

The Bush Task Group has recommended a number of reforms. I support the proposals because I believe they represent an improvement over the status quo. At the same time, it is my hope that if the proposals begin to move through the legislative process, less weight will be given to the "turf" problems of certain agencies, and even more important changes will be made.

Finally, I want to share some thoughts on what I consider to be the most critical issue facing the banking industry: the operation of the deposit insurance system. Conceived out of the chaos of the banking collapse of the 1930s, the federal deposit insurance system was intended to restore confidence and stability by protecting small depositors. It was initially opposed by the A.B.A. and by President Roosevelt, in large part due to a fear that the system would encourage excessive risk-taking and subsidize marginal banks at the expense of well-managed institutions.

While the system has been successful beyond all expectations in maintaining confidence and stability, and no responsible person would advocate its abolition, the worst fears of its early opponents are coming to pass. Deposit insurance has encouraged excessive risk-taking and has subsidized the growth of poorly managed banks at the expense of sound institutions. Moreover, in direct contrast to what was thought would be the case during the debates in the 1930s, larger banks have received a competitive advantage from the system. These issues greatly concern the FDIC and ought to be of prime interest to every person in this audience.

We need some historical perspective to fully appreciate the problem. During the first ten years of its operation, the system operated pretty much as was intended. Most failures were handled by paying off insured depositors. Smaller depositors were protected, while larger depositors were kept at risk to maintain discipline.

During the 1940s, the FDIC began to routinely handle bank failures through mergers. The objectives were laudable. A merger maintained continuity of banking services and reduced the FDIC's losses by preserving the franchise value. That a merger also had the side effect of providing 100 percent deposit insurance protection, thereby undermining discipline, was of little concern during those tranquil days.

The 1970s proved to be a critical turning point. In 1972, Bank of the Commonwealth became the first sizeable bank to verge on failure. The FDIC propped it up with direct financial assistance. In 1973, the failure of U.S. National in San Diego was handled through a merger, as was Franklin National in 1974. Numerous other failures were handled in the same manner in subsequent years, culminating in the assistance programs for First Pennsylvania in 1980 and Continental in 1984. The financial world had become addicted to de facto 100 percent FDIC insurance, particularly in larger banks.

In fairness, it should be observed that the FDIC did not act alone in this dramatic expansion of its mandate. The other regulators, Congress and the banking industry were willing partners. For example, over the FDIC's strong objections, Congress increased the deposit insurance limit to $100,000 in 1980, adopted a "full faith and credit" resolution in early 1982 and enacted a net worth certificate program for thrifts later in 1982. This year, again over the FDIC's objections, the Senate adopted a bill that would extend the net worth certificate program by three years and expand it to cover shareholder-owned commercial banks with agricultural loan problems. Moreover, the bill would emasculate the FDIC's authority to deal with one of the most pervasive problems it currently faces, the placement by money brokers of vast amounts of fully insured funds in problem banks.

The FDIC became alarmed about these trends during the late 1970s when liability deregulation was rapidly becoming a reality. At best, it is foolhardy to deregulate deposits at banks and thrifts without at the same time devising some means to instill greater market discipline. In the absence of discipline, the money simply flows to the high-risk banks that are willing to pay the highest rates.

I joined the FDIC in 1978 and almost immediately began to speak of the dangers. Though I did not use the specific term in public, I cautioned that unless we changed course, we might well be headed toward the "nationalization" of banking. After First Pennsylvania and Continental, the warning signs should be unmistakable to even the most casual observer.

Last year the FDIC submitted to Congress a study entitled "Deposit Insurance in a Changing Environment" and a few months later submitted a bill containing a number of important reform proposals, such as risk-related deposit insurance premiums. Despite endorsement from the A.B.A., Congress has not seen fit to even schedule hearings on the bill.

Earlier this year we tested a new procedure for handling bank failures of all sizes in an even-handed fashion. This procedure, called the "modified payoff," provides nearly all of the benefits of a merger without granting 100 percent coverage to large depositors. We have also advanced an alternative proposal whereby market discipline would be imposed not by depositors but by the suppliers of capital, particularly subordinated noteholders.

My purpose today is not to explain in detail or attempt to sell any specific reform measures. My goal is simply to convince you that there are serious problems in the way our deposit insurance system operates which require your urgent attention. The current system is grossly unfair to smaller banks and well-run banks and poses a substantial threat to our free enterprise system of banking. The hour is growing late, but there is still time to return to a safer course.

In closing, let me repeat what I said at the outset. It has been a privilege to have been associated with you over the years. I will always treasure the memories and be grateful for the strong support you and your Association have consistently provided. Thank you.