An address by

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This is a particularly opportune time to address the National Conference of State Legislatures. We are in the midst of a national debate on the nature and causes of the banking industry's current problems, the desirability of product and geographic deregulation and the need for deposit insurance and regulatory reforms. Banking issues have received significant attention in most legislatures in recent years.

We read and hear a great deal of commentary on these subjects from regulators, elected officials, financial leaders, media representatives and others. Some of it is intelligent and thoughtful; some of it misguided. This morning I will touch on a broad range of banking issues which have import for you both as state legislators and as users of financial services.

THE CONDITION OF THE BANKING INDUSTRY

The problems in the banking industry continue to make front-page news. It is indisputable that there are more problems in the financial system than at any time since the Depression. There are, for example, about 975 banks on our problem list, which is more than double the previous peak in 1976. During the past four years the FDIC has handled over 220 bank failures. Last year the number was 79, the highest number since the FDIC began functioning in 1934, and this year the pace is faster. Recently, seven banks failed in one day -- a post-Depression record. Problems in the thrift industry, agriculture, energy, real estate and in the international debt arena continue to plague us.

That is the bad news. The good news is that the problems are, for the most part, being handled well, and the vast majority of banks are in remarkably good shape. Problem banks still constitute a small percentage of the total, and the failure rate of about one-half of 1% per year remains well below that of any other industry.

The outlook for future loan losses is an important element in determining the future earnings prospects for commercial banks. While net chargeoffs continued to increase in 1984, the rate of increase slowed. Banks with heavy loan concentrations in depressed sectors of the economy, such as agriculture, will find their earnings performance adversely affected for some time to come. On the positive side, reduced interest expense will benefit the banking industry generally.

THE SOURCE OF THE PROBLEM

Why so many problems and failures? Some people, particularly in Congress and in competing financial services businesses, contend that the problems in the banking industry demonstrate that bankers are inept and are incapable of handling deregulation. In fact, deregulation has become the popular scapegoat -- witness the aftermath of Continental Illinois and the recent state deposit insurance crises in Ohio and Maryland. But the critics could not be more wrong.

Deregulation by itself has not been an important part of the bank and thrift problem, though combined with some other things deposit-rate deregulation has exacerbated a few problems. Deposit deregulation coupled with high insurance coverage, the use of brokered deposits and the paucity of market discipline has allowed weak or insolvent institutions to bid for funds. This has undoubtedly pushed up the cost of funds to some degree for all depository institutions, kept some institutions alive and, in some cases, allowed them to increase their losses and raise the ultimate cost of failures to the deposit insurance fund.

In the case of well capitalized banks, deposit rate deregulation has caused no problems. Bank managers who are concerned about returns to stockholders have no incentive to "overpay" for deposits. They are concerned about earning sufficient spreads to produce satisfactory returns to stockholders.

On the other side of the balance sheet, there is no evidence that expanded powers have contributed to the current asset quality problems. There has been virtually no expansion of the powers or activities of banks at the federal level. What little expansion there has been has come from state initiatives and aggressive legal challenges by some banks. Expanded powers certainly were not a factor in the interest-rate risk problem encountered by so many thrifts.

Many, if not most, of the problems plaguing financial institutions are the direct result of years of mismanagement of fiscal policy at the federal level. The federal budget deficit is easily the number-one threat to financial stability in our country and even the world. It clearly is a major contributor to the high level of real interest rates and the serious balance-of-payments problem we face. There is virtually no problem in the financial system today that would not be greatly alleviated by a substantial reduction in the deficit.

While a significant reduction in the federal deficit is the single most important measure needed to strengthen the financial system, other actions are also necessary. The first reform I would like to discuss concerns the need for further deregulation.

THE NEED FOR DEREGULATION

Expanded Products and Services

While banks and thrifts have been forced to pay more for their deposits, they have not been given the opportunity to make up the lost income. At the same time, competition also has intensified because of technological innovations and entry by nonbanks into previously sheltered product lines. The resulting pressures on profit margins are tempting some banks and thrifts to take higher credit risks. In view of these developments, banks and thrifts need more, not less, freedom to compete.

Though Congress has continued to drag its feet on the issue of expanded asset powers and services, some states have liberalized their laws. We applaud these efforts. If progress at the state level causes some discomfort on Capitol Hill, that may be all to the good, particularly if it gets Congress off dead-center.

We see no reason why banks or their affiliates should be prevented from performing any financial service. Where activities involve a potential for high risk, we believe they should necessarily be performed outside the bank in a holding company affiliate or a separately capitalized subsidiary. We see no reason why banks should not be affiliated with nonfinancial firms and believe there never were very good safety and soundness reasons for the enactment of bank holding company legislation in 1956 and 1970.

We do not need a complete wall between banking and commerce to promote safety and soundness. Because bank failures can cause credit contraction and adversely affect the system as a whole, we have developed a system of deposit insurance to lessen the effects of failures. This makes banks special.

We want banks to be operated only by people with integrity, managerial acumen and financial strength. I do not believe bankers have a monopoly on these traits; indeed, the banking and thrift industries could no doubt be strengthened by allowing companies like IBM, Sears and thousands of other smaller commercial firms to bring their managerial and financial resources to bear. The Change of Bank Control Act and our examination and enforcement powers give us the tools we need to keep undesirable people out of banking.

Nor do we want the resources of a bank to be tapped to support, or transfer a competitive advantage to, an affiliated company. Rather than prohibit the affiliation, however, we would require that the commercial activities be conducted in a separately capitalized and funded company and would impose stringent limitations on intercompany transactions. Stronger laws against tying practices could be enacted if that were believed desirable.

Before leaving the subject of deregulation, I would like to comment on the need to eliminate geographic barriers.

<u>Interstate Banking</u>

The time has come to accept interstate banking as a rational development in our system that will serve the public interest. Some progress is being made at the regional level by the states and, for the most part, this is good. However, these arrangements frequently contain restrictive elements, and they may be used to forestall moves to eliminate regional barriers altogether. Congress should set a date for the elimination of these barriers, coupled with a strengthening of the antitrust laws to limit significant acquisitions by the largest banks.

Eliminating restrictions on who can own depository institutions and where depository institutions can operate will broaden the market for troubled institutions. In a period of higher risk and change, it is important that we maximize the potential for private sector solutions to problem situations.

I am encouraged by recent developments in Congress. Earlier this week, the House Banking Committee approved landmark legislation that could lead to full interstate banking by July 1990.

DEPOSIT INSURANCE REFORM

Deregulation by itself is not enough. If we are to improve the financial system, there also must be deposit insurance reform. The deposit insurance system currently provides so much comfort to depositors that all too often they cease to be concerned about the condition of their bank or thrift, thereby sheltering the institution from private sector discipline. As a result, risk-taking is overly encouraged. One corrective measure would be to base deposit insurance premiums on risk. This would impose increased costs on high-risk institutions and allocate the cost of deposit insurance more fairly. The FDIC has strongly supported a move in this direction since 1983 and has submitted legislative proposals to Congress to implement such a system along with other deposit insurance reforms.

Another, complementary approach to restrain bank risk and safeguard the insurance fund is through increased capital requirements. The FDIC recently issued for public comment a proposal which would raise the bank capital requirement over a period of several years, and would allow a portion of the required capital to be satisfied by subordinated debt instruments. This would provide an enhanced cushion for the deposit insurance fund, introduce market discipline to the operation of banks and result in fewer bank failures.

I mentioned a few moments ago that the FDIC has submitted deposit insurance reform proposals to Congress. We are seeking to strengthen our authority over safety and soundness matters and eliminate or transfer those functions not directly related to this issue. An important element is that state and national banks would be treated alike in those instances in which states are willing and able to handle the job.

The FDIC favors deferral to state authorities whenever possible for state-chartered institutions and their holding companies. Under a proposal of the Bush Task Group, state banking departments certified as providing supervision substantially equivalent to federal supervision would have nearly exclusive jurisdiction over state institutions, and there would be no routine federal supervision. Regardless of what happens to the Task Group's recommendations, we will continue to emphasize our role as insurer of all banks and de-emphasize our role as a general-purpose regulator of state banks.

THE DEPOSIT INSURANCE FUND

How have the events of the past several years impacted the FDIC insurance fund? During the FDIC's first 47 years, our losses from bank failures were a negligible $500 million. In contrast, insurance losses have averaged about $1 billion during each of the last four years. Despite these losses, the FDIC insurance fund has never been stronger. When I became Chairman, it stood at $11 billion. It now totals $18 billion. Not only has the fund grown dramatically in aggregate dollars, it has increased as a percentage of insured deposits during the past four years, reversing a long-standing decline.

CONCLUSION

I have covered a broad range of topics today. Before concluding my prepared remarks and taking questions from the floor, I would like to pose a number of questions for you to consider. Are your state's laws governing financial institutions up-to-date and in keeping with realities in the financial marketplace? Do the supervisory authorities in your state have adequate enforcement tools? Is your state's banking department adequately staffed, trained and compensated? Is the department independent of the political process?

If the answer to any of these questions is "no," I urge you to lead the effort to bring about the necessary changes. Do not wait for a crisis to occur before you act. The issues are too important and the stakes are too high.

If we are to improve the financial system in this country, it will take the combined efforts of public officials at both the state and federal levels. I pledge to you the maximum support and cooperation of the FDIC.

Thank you.