Remarks by
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Good morning.

I am glad to be with you here in Phoenix. This is a great setting for your conference, and a wonderful time of year to be here.

I want to talk to you this morning about changes. About changes in the world and in the financial services industry, and the need to keep changing ourselves in order to keep ahead.

A cursory glance of the Fortune 500 in 1982 versus 2002 is revealing. In 1982, seven of the top ten performers were oil companies. Two were automobile manufacturers and one was a technology company. A simple list that reflected a simpler time.

In 2002, the list is a lot different. We were down to three "energy" companies. Two of these, ExxonMobil and ChevronTexaco, are the product of mega-mergers and are much different firms than their ancestors 20 years ago. The third energy firm on the list, Enron, is in bankruptcy. Two automobile manufacturers, Ford and General Motors, remain, as does the technology firm, IBM. But this year's list also includes a financial services giant (Citigroup), and two highly diversified manufacturer/retailers (General Electric and Phillip Morris). The top performer? Wal-Mart.

This trend away from established, traditional industries and toward highly diversified giants with a customer focus was mirrored in the banking industry over the last 20 years.

Here's what has happened to banking since 1982. Deposit interest rates have been deregulated. Geographic restrictions have been eliminated. Restrictions on permissible activities and products have been loosened, as well as restrictions on bank structure. There were profound advances in telecommunications and data-processing capabilities that have empowered both banks and their nonbank competitors. This all resulted in a profound transformation for both the broader economy and the banking industry.

The numbers tell the story.

Twenty years ago, there were 14,396 insured commercial banks. Today, there are 7,966 – a net reduction of 45 percent. In the past 20 years, there have been close to 1,500 bank failures and more than 9,100 mergers.

These mergers led to an unprecedented consolidation in the industry, and resulted in the concentration of industry resources in a few very large and very complex banking firms. In 1982, the largest commercial bank had total assets of $118 billion; today, we have eight banks larger than that. In 1982, the ten largest banking companies controlled about 25 percent of total industry assets. Today, the ten largest control almost half of the industry's assets. Put another way, the combined assets of all community banks with less than $1 billion are exceeded by the combined assets of the three largest institutions in the land.

Over the past 20 years, we've also seen increased competition from nonbank competitors for banks' business.

First, there has been a dramatic rise in the use of money-market accounts and mutual funds as a viable destination for the nation's savings. In 1980, 93 percent of Americans' money was held in insured depository accounts, while money-market funds and mutual-fund shares accounted for the remaining 7 percent. By 2001, however, the share held by insured depository institutions had fallen to approximately 45 percent of the overall total.

And while this was happening, a similar trend was occurring in the credit markets. In 1980, about 45 percent of all credit-market liabilities were held by depository institutions. By 2001, this figure had declined to about 25 percent. During the same timeframe, asset pools, mutual funds, closed-end funds and money-market funds have seen their share of the credit pie increase from less than 10 percent to approximately 35 percent.

These figures are impressive – and I must confess they sometimes keep me up at night. Originally conceived as a way around the interest rate restrictions 20 years ago, money market accounts have clearly established themselves in the marketplace. There are several reasons for this: the technology developed which made this market possible, the transaction costs were lower than traditional banking relationships, and the broader marketplace was experiencing substantial growth. This all led to greater consumer demand and the greater ability, on the part of some nonbank financial services firms, to meet that demand.

It is important to remember, however, that banks were not entirely left behind by this shift. A good portion of this transfer of money from demand deposits to money-market accounts and mutual funds actually occurred within the banking system. The June 2002 Call Reports, for example, indicate about one-in-four banks offer these non-traditional products. About that many also indicated they were using their businesses to sell third-party investment products. At mid-year, just under 2,000 banks reported income from investment-banking activities – including underwriting, investment advisory, and merger and acquisition services. The total income from these activities in commercial banks was $4.697 billion, or 2.3 percent of their net operating revenue on average. Further, banks first-half 2002 net operating revenue that came from sales and servicing of mutual funds was about 1.5 percent of their total.

And many banking companies also sell mutual funds, stocks, bonds, and annuities outside their commercial bank subsidiaries – yet within the holding company shell. So it appears a good portion of the shift to stocks, mutual funds and money-market accounts has occurred within (and with the help of) a bank.

This adaptability is heartening. In today's volatile marketplace, you cannot underestimate the challenge you face from more innovative, less-regulated competitors who design products strangely similar to what you offer at your bank. You cannot assume that your proprietary franchise – while certainly valuable and at the center of our country's financial structure – will last forever in its present form.

The past decade is certainly evidence of that. While this transformation has changed the industry forever – and devastated the best laid plans of many bankers – it brought much needed innovation and vibrancy to many areas of the banking system.

Industry assets increased more than three-fold since 1982, to $6.7 trillion. Capital is up, earnings are at record levels, revenues are more diversified and less cyclical than at any time in the history of U.S. banking. New risk-management capabilities allow you to follow your customer to financial products that better serve their needs. I believe this diversity in the income stream is one reason financial institutions weathered the recent economic downturn so well.

It's not just the big, complex banking companies that have benefited from the changes of the past 20 years. New charters are up: about 15 percent of all community banks are less than 10 years old – one-in-four are less than 20 years old. And community banks are healthy, too. We at the FDIC see proof of that in improved CAMELS ratings, better capitalization, less drain on revenue from loan-loss provisions, and increased noninterest income.

All of these factors indicate an important and continuing role for banks in America's communities.

But the challenges – and the forces of change – cannot be ignored. You will have to continue to adapt and reinvent yourselves to stay ahead of the curve. Remember: your share of the pie has never been richer – but it has never been smaller, either.

Not all the challenges will be long-term. Traditional problems, in the short term, will still occupy your time. The Comptroller of the Currency, last week, indicated net interest margins are likely to decline in the third and fourth quarters of this year. We have been following some deterioration in credit quality over the past few months. And while the interest margins are favorable to banks right now, there is some potential for difficulty should the interest rate environment change.

While the economic situation will likely monopolize your time in the near term, there are underlying market and technology trends that will continue to shape the industry and, indeed, test your ability to adapt. Let's look at a few of them.

Gramm-Leach-Bliley is the law of the land, and the affiliations allowed in that model seem likely to become predominant in the marketplace. While this will lead to economies of scale that are good, from an economic viewpoint, it will tend to lead to tremendously complex organizations that could be difficult to manage in a traditional sense.

Another challenge to the industry comes from nonbank providers of credit, like credit unions, that have advantages community banks do not have, yet offer similar products. Pressure also comes from less regulated entities like mortgage lenders, finance companies and other nonbank providers of credit – all of whom are competing for your traditional customers.

The entrepreneurial bank model is also gaining a larger share of consumer credit nationwide, without offering anything resembling the traditional customer relationship. This innovation is not all bad. While these institutions – subprime lenders, credit-card banks – are successfully providing access to credit, and making better use of data to understand customers' backgrounds, the fact is that this model remains largely untested through a full economic cycle. During the recent downturn, many of these banks did not survive intact. Some failed. Others had to change their business model or hold more capital and reserves against the fact that their assets were more risky. In short, the free market, and our regulatory system, worked. While the problems we've seen have led to greater regulatory oversight, the fact remains that these institutions found a new market – and found customers willing to buy their product.

There is also a new generation of banking customer coming along that seems to feel less need to do business with an insured institution. I see this trend among my friends and associates – many of them do not have a traditional banking relationship. And the demographic data we are looking at seem to suggest that my friends have plenty of company.

Then there is the issue of risk management. In the past 20 years, we have moved from transactions with fairly predictable outcomes, to an unpredictable and often volatile marketplace full of risks that have to be actively managed. This is true whether you are big or small. But it poses unique problems and interesting tradeoffs: quantitative versus qualitative decision-making. Credit scores versus customer relationships. Models versus judgment. Third-party due-diligence versus a culture of credit inside individual banking organizations. How you weigh each of these variables – and many more we cannot even anticipate today -- will determine your success in today's marketplace.

So what is my opinion about all this? What do I think should happen? Let me just say that I'm a big fan of the free market. Banks play an essential role in keeping that market operating. Regulatory interventions should only occur when they are needed to protect the safety and soundness of the system. So I’m not going to stand here and tell you this or that innovation or structure is any better or worse than any other. Today’s banking model will look very different ten years from now. The marketplace will ultimately decide the outcome. Our challenge as regulators is to balance this market-driven evolution with good policies that ensure we meet our own mission to protect the stability of the system.

This will not always be easy. There will be inevitable regulatory debates about how to handle the new ideas, the new structures and the new innovations.

Let me give you an example. We all know we are ultimately going to have to deal with the question of banking and commerce – even though the governor of California has taken the issue off the table for the time-being. We have heard from very experienced and thoughtful people about the hazards of this model, but it is worth noting the FDIC has not traditionally been as opposed as some to the question of bank ownership by commercial firms.

There are valid criticisms of this model. Those criticisms include questions about conflicts of interest, about expanding the federal safety-net to the broader marketplace, and about concentrations of economic power. These are all important and we should be thoughtful about how we proceed. But the very same questions can, in many respects, be raised about the financial holding company model currently enshrined in law and moving toward predominance in the marketplace.

In our view, Congress has given us good tools to manage the relationship between parents and insured subsidiaries. These are a great help in preventing the problems that have been identified with this sort of business arrangement – indeed the FDIC manages these relationships every day in the industrial loan company model with little or no risk to the deposit insurance funds – and no subsidy transferred to the nonbank parent.

I realize this issue worries many community bankers. In response, I would simply say that bankers must be nimble, they must innovate, and they must embrace the possibilities of emerging markets and structures. Those who put these values into practice will be the survivors in the banking marketplace of the future – not necessarily those who "Just Say No."

The banking and commerce issue is just one example presented to us by the marketplace where we – the regulators – are going to have to react. There are others. Newer, more complex, organizations raise questions about the adequacy of corporate governance. The complexities of the retail market raise questions about how to maintain good credit cultures inside the largest banks in the country. The changing demands of the marketplace raise questions about the adequacy of our disclosure policy. The dynamic nature of risk management brings us to the brink of new and profound changes in how we measure and manage capital adequacy in large institutions. The rapid transfer of customer information through technology raises questions about privacy, the use of proprietary data and to what extent the customer relationship should be regulated. The policy questions raised by the "tying" of banking products and services at the consumer level. The increasing ties between our banking industry and international arena raise questions about how we understand and manage risks from far outside our borders – and how we as regulators ensure a level playing field for our domestic industry. This is not a complete list. I could cite dozens more.

You need to understand these issues in order to stay in business and serve your customers and your communities. We regulators need to understand them in order to perform our role of safeguarding the banking system, promoting safety and soundness, and protecting the integrity of the deposit insurance funds.

Often, from the regulatory perspective, we respond piecemeal as issues arise and present themselves for decision. I believe we need to undertake a more thorough and comprehensive review, and to share what we learn with the industry in a context that is useful and informative.

So I am announcing today that the FDIC will kick off a major study on the future of banking in America. Over the next year, we will study the underlying trends in the economy and the industry. We will look at what this suggests for the future, and identify emerging policy questions likely to confront both regulators and the industry over the next decade. I've mentioned some of these today. Others will present themselves as we proceed with our work. Still others, like whether we should restructure the federal banking regulators, are already on the table and the subject of ongoing discussion.

As we work on the study, we will work hard gathering industry input and the views of the other regulators. And I will share our thinking, from time to time, as we go along. The last time the FDIC undertook a study of this magnitude was 15 years ago – when the Corporation called for many of the legislative changes that have occurred in the intervening years. Now it is time for the next step, and I expect this project will set the stage for great things to come.

As I've said already today, I cannot tell you exactly what the banking marketplace of the future will look like. But I can assure you it will be populated with institutions that wisely maintain and use their capital, who are nimble and responsive to the evolution of the markets, and who cultivate a culture of execution – who believe in getting the job done and upholding the highest standards of the profession.

It will not be easy. There will be many challenges. But I appreciate what you do every day to keep our economy operating despite all this. I look forward to working with you, and hearing your views, as we examine these important issues.

Again, I appreciate the opportunity to speak here today. I encourage you to call on us whenever we can be of help.

Thank you.

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