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Thank you very much for the opportunity to speak here today before this very distinguished audience. You are the people who make economics both discernable and useful to the wider world of business and policy.

I admire the work you've done and want to mention that our economists at the FDIC rely on this organization for ideas, opinions, contacts and a thoughtful perspective on the statistics and issues of the day. I'm grateful for the work the NABE provides and look forward to continuing what we view as a very productive partnership.

We come together today at a pivotal time in our nation's economic history. In the past two decades, we've seen a free-market consensus develop around an agenda of broad deregulation in our economy. As a result, we are witnessing a significant transformation in the marketplace brought on by the revolutionary economic events that characterized the end of the twentieth century.

Deregulation, globalization, and far-reaching technological innovation have profoundly altered our economic landscape over the last 20 years.

This era of tremendous transformation had a significant impact on the way financial services are provided. Looking back over the last two decades or so, you can identify two distinct periods for banks: the near-death experience and the golden age.

The tipping point came in the early 1990s. By 1991, the taxpayers were on the hook for problems in the savings and loan industry and hundreds of banks had high volumes of troubled loans and weak capital positions. Banking was a big part of the problem in that recession. Not long after this, Bill Gates was quoted as saying that "banks are dinosaurs."

As you're probably aware, the banking industry's turn-around was rapid and sustained. A simple comparison drives this home. The decade of the 1980s saw virtually no growth in total earnings for the commercial banking industry – the figure hovered around $15 billion. By contrast, during the 1990s annual earnings grew almost five-fold to just over

$70 billion. And the golden era continues in this decade; last year commercial banks earned just over $100 billion.

I used to think that bank performance was closely tied to the economic cycle. But this may have changed. Before, during, and after the 2001 recession, banks have been a pillar of strength for the U.S. economy. As a sector, banks have added jobs consistently since 2000. Most of their growth has been in mortgage and consumer lending, in particular, because that's where the loan demand has been. But the industry is primed to make more business loans when demand turns up there as well.

This serves to remind us of something we all learned in undergraduate economics – a healthy, well-functioning banking industry is key to the economic vitality of our nation. We also learned that banking systems seem to function better when the government provides a safety net with features such as a lender of last resort and deposit insurance. At the same time, the presence of a safety net tends to undermine market discipline, thus creating the need to supervise and regulate banks in order to prevent excess risk-taking.

This leads to a classic economic trade-off between letting the market work and appropriate government intervention. In banking, this trade-off has played out in how banks are permitted to compete with other financial services providers, what products and services banks can offer, how highly leveraged they can be, and even restrictions on who can own banks.

In the crisis period of the1980s and early 1990s, this trade-off was out of kilter and we saw the consequences of that imbalance. Over the past decade, a much more desirable balance appears to have been struck. As we look to the future, the question is whether we will continue to strike the right balance. Will bank regulators and policymakers manage these trade-offs in a way that will allow banks to continue to play their dynamic and essential role in our economy while maintaining financial stability?

This morning I want to talk to you about two major trends that we at the FDIC expect to be extremely important in the future and how these trends will challenge our ability to strike the right balance. The first trend is well underway and will continue: the consolidation of the banking industry. The second trend is not as far along, but has the potential over the next decade or two to bring fundamental changes – the mixing of banking and commerce.

Let me start with consolidation of the banking industry, which as you may know, has been dramatic over the past 20 years. During the crisis period, consolidation was disorderly, with bank failures playing a significant role. During the post-crisis period, consolidation was much more orderly as banks responded to the removal of restrictions on interstate banking and sought to realize economies of scale and scope.

The story of banking in the U.S. is fast becoming a tale of two industries. At one end are the dozen or so large complex banking organizations whose size is measured in the hundreds of billions. Some have assets in the range of one trillion dollars. At the other end are thousands of community banks, which typically have less than one billion dollars in assets.

Two data points help convey the scale of this transformation. Since 1985 the number of community banks declined by half, from over 14,000 to just over 7,000 today. In 1985, the top ten banking organizations held 16 percent of industry deposits. Today, their share is 40 percent.

This consolidation trend suggests the largest institutions may grow even larger and community banks will continue to decline in number. We could well see a banking industry with a few institutions having assets in the trillions of dollars, and perhaps only half as many community banks as we have today. This trend will ultimately pose some significant questions for policymakers, and will have a profound impact on how we administer the safety net for the regulated financial services industry.

To begin, we believe a disparity of this magnitude among banking organizations requires us to rethink the way we administer the deposit insurance system.

The largest banking institutions are global, highly diversified organizations. They are well positioned to absorb losses from local economic problems or idiosyncratic risks in any particular lines of business. The external risks posed to these firms are essentially macro risks – reflecting the same factors that could threaten the entire financial system. At the same time, any internal risks arising from the challenges of managing such large, complex organizations could also pose risks to the system as a whole.

A rough analogy might be drawn using the distinctions between standard risks in life insurance and catastrophic risks in property and casualty insurance. Life insurance is based upon textbook actuarial science, which involves the pooling of many individually small and somewhat independent risks. Catastrophic risks to property, like those posed by hurricanes or earthquakes, are inherently different. Here, a single event can lead to losses so large as to threaten the viability of the insurer. That is why catastrophic risks are not always amenable to the same arrangements we observe in the life insurance industry. Instead, we increasingly see them addressed with specialized financial instruments like catastrophe bonds, weather derivatives and so forth.

As a result of the ongoing consolidation in the banking industry, I am suggesting today that it is time to recognize these same distinctions between the largest banking organizations and typical community banks.

There are at least two important questions to consider. One is how do we supervise and regulate the largest institutions, in order to minimize the probability that they will ever call on the safety net to maintain stability? And another is how do we design safety-net arrangements to work most effectively in an industry consisting of a few large banks on one side and thousands of community banks on the other?

Regarding large-bank regulation and supervision, it is my view that capital requirements form the foundation of any responsible supervisory regime. An unhealthy erosion of the large-bank capital base could result in instability and unnecessary risk to the deposit insurance funds. It could also result in a highly intrusive supervisory environment where management decisions are excessively scrutinized.

Neither outcome would be healthy for our economy or our banking system. And this approach would not be consistent with the principle that the free market – not the regulators – should govern the direction and future of banking in America.

The capital held by U.S. banks is currently subject to regulation under a framework established by G10 countries in 1988 and enhanced considerably in the U.S. since then. These “Basel I” standards specify the amount of capital that must be held against assets of varying types and risks.

This system is simple and has served us well. But there are structural weaknesses. It ignores the superior information about bank risk embodied in the risk-management models of the largest banks. If supervisors could better harness this information, then the capital requirement for each institution could be more closely tailored to the particular assets it holds. This is the “perfect world” we are trying to capture in the latest round of negotiations on capital – commonly referred to as Basel II.

While we support this effort, we expect this agreement to result in a significant reduction in risk-based capital requirements in the largest, most complex, banking organizations in the world. This result may well be the product of some very sophisticated risk-management techniques, but we believe the role of capital is broader than that. Capital aligns the interests of the insurer and the managers and owners of the insured bank. Capital also compensates for errors in the capital models themselves. And, finally, capital provides an indispensable cushion against unexpected events and unanticipated shifts in the marketplace. So, let me repeat, getting capital right is the cornerstone of any responsible regulatory approach to the continuing trend of banking industry consolidation.

On the second question regarding appropriate safety-net arrangements, current law already recognizes that the largest institutions may individually pose risks to the overall financial system. In the event of bank failures, the FDIC as receiver of failed institutions generally is required by law to use the least-cost resolution method. The exception is for failures that are determined to pose systemic risk.

Under current law, systemic risk determinations are made jointly by the FDIC, the Federal Reserve, and the Secretary of the Treasury in consultation with the President. The extra costs associated with protecting uninsured creditors in such cases must be paid for through special FDIC assessments – the burden of which would fall most heavily on the largest insured institutions.

In my view, these provisions, enacted in the wake of the banking crisis as part of the FDIC Improvement Act of 1991 (or “FDICIA”), represent a positive step forward in the development of sound public policy regarding the large-bank safety net. For the first time, they outlined an explicit process for financing the extra costs of large-bank failures, primarily through contributions by other large banks.

This has been helpful and necessary, but as consolidation proceeds it may no longer be sufficient.

From a safety-net perspective, the largest banking institutions and community banks are apples and oranges. The disparity between these two classes of institutions will continue to grow. They should be treated separately.

The Basel II reforms ratify this thinking in some respect, because they already contemplate a two-tiered system of capital regulation. One set of standards for large banks, one for everyone else.

As a practical matter, we have had a two-tiered approach to bank supervision for some time, given that community banks are examined at discrete intervals while the largest institutions are examined in real time by teams of examiners that are on site every day.

Furthermore, when the Congress established risk-based premiums for deposit insurance, the law explicitly authorized separate pricing systems for large and small banks. Current provisions in the law prevent the FDIC from acting on this in a meaningful way, and we have asked Congress for reforms that would address this issue.

We should consider building on these precedents and establishing a new safety net that is explicitly two-tiered, with one set of arrangements for the largest institutions and separate arrangements for all others.

Under the current system, community banks are obligated for extra costs associated with the systemic risk exception for the largest banks. The large institutions, on the other hand, have paid for deposit insurance losses that have arisen disproportionately from the failures of small, community banks. Neither group views these arrangements as optimal.

What would a two-tiered safety net look like? I don’t claim to have the details all worked out, but it is possible for me to envision an arrangement that allows the largest institutions to opt out of the current system and join a separate risk pool. The Basel II banks might be a useful starting point for eligibility.

Since these institutions already will be subject to a different form of capital regulation and real-time supervision, they might also pay differently for their safety-net protection and be subject to a different set of regulatory requirements than community banks.

I want to be clear: the idea is not to favor one group of banks over another. Rather, we need to recognize that a one-size-fits-all approach limits our ability to strike the right balance for both small banks and large banks.

In addition to developing the two-tiered approach, we need to tap the power of the marketplace to inform our efforts to manage the risks we face from a rapidly changing banking industry.

One approach we are considering is to have the FDIC develop specialized financial instruments, like bonds or reinsurance contracts, to use the power of the marketplace to help us measure and manage the unique risks posed by these two classes of institutions.

While this is a natural outgrowth, really, of the dynamics already resulting from the trends of the last 10 years – it is nonetheless a concept that is significantly different from how we administer our system today. We at the FDIC are preparing an options paper, built around this approach, which can serve as the basis for further discussion on the topic.

But what about community banks? As the largest banks get bigger, does this mean that smaller banks will be unable to compete? Community banks face many challenges, some of which are related to the relative demographic decline of the rural communities. But community banks play a critical role in meeting the needs of households, small businesses, entrepreneurs, and civic life in general across America.

The chartering of small, locally controlled depository institutions is an American tradition. These businesses are inextricably linked to our traditions of self-reliance, homeownership, and entrepreneurship. This healthy arrangement is part of the reason that up to three quarters of all net new jobs are created in firms with fewer than 500 employees.

Americans will continue to want locally controlled financial institutions that understand their needs and participate in their way of life. That is what the marketplace is telling us. Amid this long-term wave of bank consolidation, we've seen some 1,200 new banks chartered since 1994. This has served to expand choice in the marketplace and serve as a check on the economic power of the large institutions.

This model only works, however, if the barriers to entry remain low enough to ensure new charters can come into being. If we stifle the innovation in community banking, we threaten the process of entrepreneurship in the U.S. economy. We must guard against burdening them with a regulatory system that is complex, duplicative, and primarily aimed at containing and managing the risk in large institutions. Moving toward a two-tiered approach – in supervision, regulation, and the application of the safety net – would help to rationalize bank regulation and minimize the burdens it places on all institutions.

The second trend I want to talk about this morning is the slow march of the marketplace toward more business combinations between banks and commercial firms. In my view, this trend is nothing more than the natural outgrowth of dynamics that have been underway in banking and bank regulation over the last two decades.

There has been a significant evolution in regulatory policy over this period. When I started in banking, there were ceilings on the interest rates we could pay on deposits and strict limits on where we could do business. These restrictions became unsustainable in the interest rate environment of the late 1970s and during the banking crisis in the late 1980s. Congress responded to these pressures by first deregulating interest rates and – later – eliminating most of the interstate branching restrictions.

This deregulatory trend did not end there. Other barriers came under pressure during this time as well. The Glass-Steagall restrictions on banks' ability to offer other financial products, or to affiliate with companies that offered those products – such as securities firms and insurance companies -- seemed increasingly antiquated. As the financial system underwent a transformation driven by technology, financial innovation, and the free-market, these Depression-era laws increasingly harmed banks' ability to compete.

This came to a head with the proposed merger of CitiBank and Travelers in the late 1990s. In response, Congress passed the Gramm-Leach-Bliley Act, allowing banks to affiliate with securities firms and insurance companies through a new vehicle called a financial services holding company. These companies are regulated by the Federal Reserve through what is known as umbrella supervision.

This approach is not intended to subject non-bank affiliates to bank-like supervision. Still, these securities firms and insurance companies, which had been and continue to be regulated by the SEC and the state insurance commissioners, are now also subject to a layer of oversight by a federal banking regulator.

As useful as Gramm-Leach-Bliley was, it only ratified the status quo. In the coming decade, the market will continue to press for more efficient combinations of banking and commerce that deliver results for the consumer. At present, the primary vehicle for this evolution is a little known state banking charter known as the industrial loan company, or ILC.

A key feature of the ILC charter is that a firm, whether it is a financial services firm or a commercial firm, may own a bank-like charter without submitting to regulation by the Federal Reserve. Instead, these banks and the terms of their relationship with their parent companies are regulated by the FDIC.

Many non-financial companies like Volkswagen, Harley-Davidson and BMW are using ILCs to more efficiently deliver products and services to their customers. The result is greater efficiency and a smoother integration for banking customers between the financing and the underlying product.

This seems like progress, but in banking policy circles, the ILC charter is controversial. There are concerns that these combinations may create unacceptable conflicts of interest, that they inappropriately expand the federal safety net, and that they may yield undesirable concentrations of economic power. Each of these is a legitimate and important concern.

But the real flashpoint here is whether large retail organizations should be allowed to hold a banking charter. In my view, if, and only if the marketplace decides that these organizations can offer banking services at lower cost and greater convenience – and if such banks are required to operate in a safe and sound manner and in compliance with appropriate banking laws – then we need to consider carefully what public policy purpose would be served by prohibiting such arrangements.

As the marketplace continues to press its case for these combinations, the important policy question becomes how these combinations between banks and commercial firms should be regulated. Will commercial firms that choose to enter the banking business be subject to umbrella supervision, thus bringing more and more economic activity into a regulatory framework designed to administer the nation's financial safety net?

Or will we limit our regulatory attention to the bank itself, the entity that has the direct connection to the federal safety net, and let the discipline of the market oversee the nonbank activity? We have used this safeguard approach at the FDIC for years in our supervision of industrial loan companies and we believe it is the most appropriate way to ensure effective regulation of banking subsidiaries without unwarranted regulatory intrusion into the marketplace.

The challenge on this issue is really no different than what regulators have to deal with every day: we must strike the right balance between the principle of letting the market work and the principle of stability, soundness, and responsible regulation.

How we go about this task is of vital importance. We can be very prescriptive, and thwart innovation. Or we can lay a groundwork of high standards – like meaningful capital requirements, effective supervision, protection of the insured entity, and efficient resolution of problem institutions – and let the marketplace work its will.

I believe we can achieve this balance, but I caveat my optimism with one concern. As economists, you know that everyone faces economic incentives. It is nearly impossible to construct incentives for regulators to move beyond the narrow question of turf and fully embrace the principles of "good government."

This is not because regulators are bad people – far from it. Rather, it is because it is so hard to hold us accountable on the question of efficiency. There is no share price to benchmark our performance. We have no profit and loss statement at the end of every quarter. We occupy a monopoly position in the marketplace. As a result, we tend to tolerate inefficiencies, overlaps, and regulatory burden that would be quickly wrung out of the system were we exposed to the demands of the market. As we modernize our system of financial regulation, this will continue to be a challenge.

The time to think through our approach to these questions is now. Times are good for the financial services industry and no crisis imperils our system. The options of policymakers are not limited by our times or by our circumstances. They are limited only by our vision, our inherited point of view and the conventional wisdom.

But getting the right answers to these questions will be important for banks, for their customers, and for the performance of our overall economy. We must build a regulatory platform that both recognizes the primacy of the market in determining the future of banking, and administers an effective and efficient safety net. This is the challenge for policymakers and for bankers as the industry continues to evolve and continues to play its vital role in the American economy.

We will continue to look to you and members of your profession for sound advice and input. These policy decisions will be made in the political arena, but they need to be informed by the facts and by sound economic principles.

You can help. I hope you will consider joining us in research partnerships – so we may benefit from your expertise as we tackle these important questions, and as we set up a Center for Financial Research to facilitate just this kind of interaction. But whether you work with us, or use the data we collect from the industry to inform your own work, we hope to continue our productive alliance with NABE, and with your colleagues in academia to inform and illuminate our own approach to these important issues.

Thank you again for the opportunity to speak here today.

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