# Rebuilding the Financial Strength of the U.S. Banking System

***by E. Gerald Corrigan***

I am delighted to have the opportunity to address this distinguished audience. Once again, Si Keehn and his colleagues deserve an enormous amount of credit for organizing a timely and stimulating program.

The topic assigned to me for my remarks today—"The Economic Implications of the Declining Importance of Banks"—is not one that I would have chosen because it is not at all clear to me that banks are of declining importance. Indeed, I would argue that certain of the *functions* performed by banks are no less important—and may be more important—today than was the case in the past. In saying that, I am quite familiar with the mass of statistics that show falling market share for banks in virtually all aspects of lending and credit extension. I am also quite familiar with the fact that other elements of the bank "franchise," including the deposit-taking function and the operation of the payments system, have been eroded by a combination of regulatory, technological, and competitive forces.

However, I still believe that banks are special, even though I suspect there are more than a few in this audience who would regard that point of view as old-fashioned, wishful thinking on my part. Perhaps that is so, especially in a setting in which we would all accept the fact that the decade of the 1980s was surely the most difficult such interval faced by the U.S. banking system since the 1930s. Indeed, the legacy of the 1980s that produced a weakened and vulnerable U.S. banking system resulted from a combination of (1) rising asset quality problems, (2) rapidly rising operating costs, (3) competitively depressed margins and spreads, (4) weakened capital positions, and (5) an underlying banking structure that was (and is) increasingly out of step with the realities of the marketplace here and abroad. To some extent, those sources of weakness and vulnerability were muted as long as overall economic activity remained relatively robust. However, when the pace of economic activity slowed beginning in 1989, the scope of the problem became more evident, as eventually reflected in the sharp fall in many bank stock prices and the very appreciable widening of spreads on bank debt relative, for example, to Treasury securities.

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Recently, there has been a pronounced reversal of those earlier trends in that equity and debt markets have favorably reappraised the outlook for banking institutions. This reappraisal seems to be driven by a number of factors:

- First, there are straws in the wind to suggest

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that the rise in problem assets in the banking system may have peaked, even though it is true that the level of problem assets remains very high by any historical standard. Certainly the LDC debt problem is now largely behind most

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If—and this remains a big if—the drag on bank earnings arising from the very high level of nonperforming and underperforming loans begins to abate, there is no question that it can have a favorable impact on bank profits and capital retention.

- Second, despite the enormous drag on capital resulting from charge-offs and loan-loss provisions, major banks have substantially bolstered their capital positions over the past several

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In this regard, it should be stressed that the 1988 Basle Capital Accord was one of the truly major banking and bank supervisory events, not just for the 1980s but for the postwar period as a whole. Not only did it represent a major step in the direction of achieving a more level playing field in international banking and a major step in the direction of strengthening the hands of supervisory authorities, but it also made it more respectable for bank managers and directors to do what had to be done in any event, namely, to become more aggressive and innovative in bolstering capital positions.

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- Third, banking institutions are also becoming much more aggressive in their efforts to contain operating costs. To be sure, some of this is arising in the context of mergers, but even in the absence of such events, individual banks are having a significant degree of success in curbing operating costs. This process is painful and difficult, perhaps especially for the tens of thousands of workers who are being displaced as a part of the effort. However, its potential implications for the "bottom line" and for com-

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petitive positions of individual institutions could be very powerful, especially if the drag on earnings arising from nonperforming loans were to abate materially.

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While these and other factors go a long way in explaining the reappraisal by debt and equity markets of the outlook for banks and the banking system, the fact remains that rebuilding the financial muscle of the U.S. banking system will be a long and difficult process that is far from risk free. Uncertainties about the near-term economic outlook in the United States and in much of the world tell us that in rather unambiguous terms. But even if the national and international economy were to perform in a satisfactory manner over the period ahead, the question still remains whether—as a matter of public policy—we should care what role the banking system will play in our economic and financial affairs over the longer term.

Some might answer that question by suggesting that the market and technological forces that have already undercut so much of the historic banking "franchise" are so powerful that we have no practical choice but to allow nature to take its course and quietly permit banks to follow the course of the dinosaurs. Others might suggest that we should somehow try, through legislation or regulation, to recreate a banking franchise along the broad lines of what we had in the past.

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Neither of these approaches appeals to me. The latter—call it reregulation for short—simply will not work, and the former is, to my way of thinking, too risky as long as there is still another alternative. That other alternative, of course, would be for the Congress to enact the kind of progressive legislation I and others have been suggesting for years. To be sure, structural reforms in the U.S. banking and financial system such as the repeal of McFadden, Douglas, and Glass-Steagall will not solve all of our problems, but they will help to create a legislative framework within which the process of change and adaptation can move forward in a more orderly and a more stable manner.

There are any number of reasons that the alternative

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of progressive and broad-based reform of our banking laws and regulations still strikes me as the most prudent and reasonable course for public policy. Most of those arguments have been cited over and over as the debate on this subject has dragged on for years. I do not intend to repeat those arguments in any detail today, but I would like to call your attention to two aspects of the debate that I believe are often ignored or downplayed:

- First, given the structural changes in banking and finance that have occurred in virtually all industrial countries, the prevailing banking structure in the United States is simply out of step with banking structure in the rest of the world. The competitive implications of this situation aside, our current arrangements are going to make it increasingly difficult to administer a policy of national treatment in our relationships with other countries. That is, as U.S. financial

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  firms operating abroad benefit from the added flexibility available to them in other countries, foreign firms and their governments may—and probably will—become increasingly frustrated with the barriers they face in the United States. This situation brings with it the potential for new and avoidable tensions between nations in a setting in which trade and other economic and financial tensions between nations are already too high.

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- Second, while the banking franchise is not what it once was, it remains true that the banking system performs certain unique functions that are important to our economic and financial well-being. For example, the banking system remains the lender of next to the last resort—a function we saw performed in almost textbook fashion at the time of the 1987 stock market crash. Similarly, even though there are now important elements of payments and settlement systems operating outside the traditional banking system, in one way or another all of those payments and settlement systems still depend on the banking system to achieve true finality, and/or they depend on the banking system for backup sources of liquidity, especially in times of stress. Finally, it is by no means clear to me that many of today's capital market instruments would enjoy the widespread market acceptance that is now the case were it not for the role of various forms of credit enhancement or backup liquidity facilities provided by the banking system.

In citing these functions performed by the banking system, I recognize that an argument could be made that some other class of institutions might—with the passage of time—be able to fill the void in the absence of a viable system of commercial banking. That may be true, but I, for one, believe it would be imprudent to leave to chance how well and by whom these activities would be performed if the banking system became so weak and so impotent that it could not step up to the task, especially in times of stress.

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For these and other reasons I still believe it is important that we seek to encourage and maintain a financial system that has a strong and competitively viable banking system at its core. To be sure, the precise nature of the banking franchise will continue to evolve in ways that are not always foreseeable. But to assume or to conclude that we are destined to live with some other, unspecified system strikes me as potentially very dangerous, especially in circumstances in which the initial steps in rebuilding the financial strength of the banking system seem to be taking hold and in circumstances in which we have hardly exhausted the legislative and regulatory remedies capable of further strengthening the competitive and financial position of the banking system.

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With a lot of discipline and vision on the part of bankers, regulators, and legislators—and perhaps with a little luck—the U.S. banking and financial system might emerge from the agony of the eighties with newfound strength and vitality. This will permit the banking system to perform those crucial functions that are so central to financial and economic stability, even as those institutions are better able to earn reasonable returns on capital—returns that, at the end of the day, must be there. If the returns are not there, the capital will not be there either!