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News Release

FINANCIAL STABILITY IN CHALLENGING TIMES

REMARKS OF

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Periodically, events are of such magnitude or significance as to shape the perceptions of nations, and the course of history. I suspect that most of us will always remember where we were when the Apollo astronauts first landed on the moon, or during the Cuban Missile Crisis. Earlier generations had their defining moments as well, whether the bombing of Pearl Harbor, or the Crash of 1929. My three sons think that I am old enough to remember another such event -- the firing on Fort Sumter. Though I don't recollect the occasion with perfect clarity, it is another example of this type of defining moment.

Perhaps never before has the commencement of hostilities on a massive scale been carried live on television to millions of viewers. I suspect that many people will long remember the tension surrounding the opening salvoes of Operation Desert Storm. The events now unfolding in the Persian Gulf are certain to affect us, and the world we live in, for a long time to come.

Of course though we will be affected by this war that we did not seek, we would also have been affected by allowing Iraq to invade and pillage a peaceful country, and to use Kuwait's considerable resources to accelerate Iraq's development of nuclear and other weapons of mass destruction. Certainly all of us should stand solidly in support of the men and women of many nations that are putting their very lives at stake to try to build a safer and more peaceful world for our future.

The resolve and determined leadership of President Bush have been instrumental in the handling of this problem from its inception. At such a momentous time of challenge, he has shown what the word "leadership" really means. Indeed, more than any other factor, the President has helped to make sure that this grave situation has been addressed through the combined efforts of the world community, rather than by any single nation standing alone. For the future, it is reasonably clear that we will continue to live in a world filled with many international challenges, including periodic threats to peace and stability.

In this future environment, the United States will need a strong and growing economy. Among other things, achieving and sustaining economic success demands that the United States equip itself with a strong, tough and resilient financial system. That system has to be capable of absorbing unexpected shocks and still delivering low cost capital to the people who want to conduct research, build new plant and equipment and create economic growth.

This requirement is not an option or a frill. Rather, it is an absolute necessity for maintaining a vibrant and competitive economy. Just like the need for a car to have a chassis, and a building to have a foundation, we cannot hope to have economic security if our financial system is brittle and typified by firms that are financially anemic.

It is of course easier to desire a strong and competitive financial system than it is to achieve it. However, I would suggest that we take a lesson from the Patriot, which is currently proving itself in the face of great difficulties. Now we did not find the Patriot missile in a basket on the doorstep. When we determined that our security required such a sophisticated defensive system to protect against cruds who own Scuds, we set about to put our knowhow and technology to work to build a reliable defensive system. So too, I believe that the United States must identify what we want in a financial system, research where we have gone wrong in the past, design and engineer a solution, and then build and deploy it.

Cataloguing our weaknesses in the financial sector is not an especially rewarding assignment. Suffice it to say that the disaster of the thrift industry still lingers in the form of a massive and prolonged effort to dispose of literally tens of billions of dollars in thrift assets. Securities firms have just finished their worst year in terms of earnings in nearly a generation, though their capital position remains extremely strong. Several major insurance firms have been forced to absorb substantial losses on commercial real estate and other problem assets.

Perhaps the greatest area of current concern in our capital markets today is the situation facing the banking industry. At the outset it is important to understand that the situation of the banks is NOT like that of the savings and loans in several respects. First, the banks have more money -- both customer deposits and capital. Second, there are far more banks than there were thrifts, meaning that there are more institutions over which losses can be spread. Third, the business of making intermediated commercial loans is still an important business with strong demand that cannot fully be satisfied by other types of firms.

Therefore, I believe we should all acknowledge that it is in the national economic interest for the United States to have a strong banking system. With about $200 billion in capital and many extremely well-run institutions, the banking industry possesses great internal strength, and much more resilience than many observers suggest. However, it is clear that there are significant problems facing the industry, and the question before us in large part has to be whether there are things that we can do to improve our banking system so that it becomes even stronger and more efficient that it is today.

As most of you know, the Treasury Department is in the final stages of completing perhaps the most ambitious and thorough review of our banking system during the postwar era. A number of people criticized (erroneously, in my view) the President's proposals for stabilizing the thrift industry that resulted in the FIRREA legislation because they did not propose a complete overhaul of deposit insurance and other structural issues in our banking system. However, we included the Treasury study in FIRREA not to duck those issues, but to prepare for them thoroughly.

I do not know what the final proposals from the Treasury will be, or what the President will ultimately decide. However, I believe that the Treasury effort has been wide-ranging and detailed, and that the proposals are likely to include a number of bold steps that are long overdue for action. Ultimately, these proposals will not satisfy every interest group, or every regulatory agency. However, I believe that the need for a fundamental overhaul and modernization of our system is so great that we must face up to the task.

The national interest in a strong and efficient financial system simply must take priority over the parochial views of interest groups and individuals. In this effort it will be the President who needs to identify the outlines of the course for the future, and the rest of us who need to see if we can contribute constructively to achieving the best possible result.

In trying to identify the steps necessary for the future. I would hope that we would consider carefully those elements of our current system that have worked well to give us stability and efficiency. In this regard I believe, perhaps not too surprisingly, that a number of traditional elements of securities regulation deserve consideration for wider application in the banking system. For starters, I would suggest a bit of our admittedly old-fashioned belief in solvency.

Strength means more than avoiding imminent failure by having adequate current cash flow and earnings. We need a financial system that is able to take risks by providing capital for new ideas, and for financing projects that may require a long term commitment before they are successful. But underwriting a five or ten year development program takes an institution that can afford to take the long view, and that can only be an institution that is strongly capitalized.

Happily, strong capitalization is not a problem in the securities industry today, which has the highest level of capital in its history. In addition to the absolute amounts of capital, that capital is not composed of unrealized losses on securities or other assets. Its adequacy is tested and measured each and every day, resulting in a daily dose of market discipline against excessive risk-taking by securities firms.

Both to meet higher capital requirements of the regulators and to offset massive loan losses, banks are currently faced with a need to raise large amounts of capital or to shrink their asset base considerably. One reason that shrinkage has to be chosen by many institutions (thereby helping to create a perceived "credit crunch") is that we have artificially limited those who can invest capital in U.S. banks.

Because of a doctrine of separating "banking and commerce," which was probably a very bad idea in the first place, we have limited banks to seeking domestic capital investment from individuals and other banking organizations. As a result of the Bank Holding Company Act, "commercial" firms are unlawful sources of major investment in a U.S. bank. It takes 13 pages of the Code of Federal Regulations and 47 reported cases over the past 16 years to define what it meant by "non-banking" firms under this law. However, since these "commercial" firms have approximately 80% of all domestic capital, it should be apparent that this rule severely limits the sources of domestic capital that are available to our banks.

The prohibition against mixing banking and commerce now enshrined in the Bank Holding Company Act inevitably raises the cost of capital to banks, and makes it much more likely that a failed U.S. bank will be sold to foreign investors. Ironically, we allow U.S. banks to be owned by foreign banks with commercial affiliates, but we resolutely make it unlawful for IBM, G.E. or AT&T to consider owning a bank, or at least one located in the United States. Prohibited from investing in U.S. banks, American Express and other firms have often invested their capital in foreign banks, a curious result from a U.S. statute.

This banking and commerce prohibition looks utterly counterproductive to me as a regulator. It limits the availability of capital, it increases foreign ownership of the U.S. banking system, it creates enormous regulatory costs to administer, and it restrains competition and shields badly performing bank management from accountability for their performance. Other than that, it is a fine idea.

About the only real argument raised in support of this policy was articulated by Tevye while fiddling up on the roof -- "Tradition!" However, our traditional approach has witnessed a once strong and vibrant banking industry shrink in both competitiveness and solvency. Only ten years ago there were nine U.S. banks with at least two AAA credit ratings. Today there are not any. Indeed, we are now at the once unthinkable point of discussing the need for a "recapitalization" of the FDIC. Under these circumstances, "tradition" is not enough of a reason for continuing to exclude the other 80% of U.S. private capital from the banking system.

Merely broadening the "banking and commerce" prohibition to "finance and capital" would not be any help. Under such an approach we would still need to have 50 pages of regulations to define commerce, new acquisitions or investments would have to be barred until a federal agency determined that the "finance" barrier was not being violated and issued a permit. Millions in legal fees and years of litigation would still be necessary to determine what type of firm would be eligible to put its capital in front of the taxpayers.

Moreover, any such system would not represent a "two way street" in competitive terms, which is an absolute prerequisite for establishing a fair competitive environment. Of course I should admit my bias. Nine of the 20 largest securities firms are owned by diversified firms, and some of them like G.E. and Sears are definitely "commercial" firms. These diversified parents also invested about $3 billion in capital in their securities firms last year, which was a large reason that a very bad year in terms of earnings did not reduce industry capital. At the SEC, we believe that such firms have strengthened, not weakened, the securities industry. It is long since past the time to repeal this senseless restriction on investment in U.S. banks.

If financial strength is one of the principal goals for our financial system, then there are a number of other steps that should be taken to make it more likely that we can achieve and maintain strong institutions. In addition to removing investment restrictions, we should permit both our banks and our securities firms to operate from coast to coast without state barriers or the cost and operational burdens of duplicative registrations.

In an era of global markets, it should not require the action of 50 separate states to register a Merrill Lynch money market fund for distribution, much less an offering of equity securities. It is frustrating that as of 1991 Great Britain will allow the use of a prospectus filed in Berlin, but it will still not be legal to use automatically a prospectus filed with the SEC in the great State of California. By recognizing exchange or NMS listed stocks, the states have reduced the burdens of blue sky registration, but more should be done. At the same time, states should continue their important work in prosecuting securities fraud, which does not require a prior review of prospectuses.

Another desirable step to promoting a stronger financial system would be improved disclosure and accountability. Put quite simply, investors and creditors (including uninsured depositors) can't be expected to seek out and reward more solvent firms if they do not have enough information to determine the true condition of a bank or other firm. When a bank is beginning to experience problems, whether they are losses on investments, imprudent lending practices, rising levels of deficient compliance with laws or many other items, why shouldn't investors and depositors be told as soon as possible?

In part this is of course a matter of philosophy. Securities regulators believe firmly in the cleansing power of sunlight. Bank regulators have traditionally preferred a shroud of secrecy over the problems of a bank, seeking to avoid disturbing public confidence while working with the bank to resolve its difficulties and return it to health. This is certainly one point of view, and many times the strategy is successful.

Unfortunately, many times the strategy isn't successful. In fact, it wasn't successful in 2,000 cases since 1980, when banks or thrifts ultimately had to be closed. Though uninsured depositors have frequently been shielded by the FDIC's "too big to fail" doctrine, the investors have been hit extremely hard. By our count over $10 billion in losses have been incurred by investors in banks and thrifts during the past five years alone. Many of these investors might have benefited from greater disclosures of the bank's financial posture. Indeed, only two years ago more than 20,000 investors held about $2 billion worth of securities in the Bank of New England. Sadly, that investment is now "Gone with the Wind."

Those investors, and others like them, should receive much more expansive disclosure from banks and thrifts of their risks. Among other things, much better information concerning portfolio concentrations, loan exposure, and other financial data should be easily accessible to investors. We should at least consider whether investors should be able to know the bank's rating by its regulators, and possibly also have access to the bank's examination report as a very useful exhibit to the 10-K.

We are working closely with the FASB to consider both financial disclosure and financial accounting practices and ways in which they can be improved. One possibility is the broader use of market values, rather than the "Once Upon a Time" cost of financial instruments with a readily determinable and reliable market value.

Of course investors would not be the only beneficiaries of better and more reliable valuation of bank balance sheets and earnings. It is difficult for me to understand why our capital requirements should not be based on reliable market valuations. After all, what use is it to require 8% capital if 4% is actually "unrealized losses on investment securities", or "delayed recognition of likely loan losses" for that matter?

Capital is only useful in promoting financial solvency if it is real, and it is usable to absorb losses. Pretend or make-believe capital like the thrifts used is simply a cover for allowing an institution whose management has already demonstrated dubious skills to play double or nothing with publicly-backed funds.

To achieve its purposes, capital needs to be measured realistically, and there should be mechanisms to intervene swiftly when a firm has begun to dip its toes in the sea of insolvency. Of course, with broker-dealers we measure the value of firm positions daily, and if threshold minimum levels are breached immediate consequences ensue. We are unyielding and unbending when it comes to capital requirements. If a firm is undercapitalized it simply will not operate.

Drexel's collapse last February represented by far the largest failure in history of a securities firm. Though Drexel was 15 times the size of the National Bank of Washington, and $6 billion larger than the Bank of New England, it was not "too big to fail." It was also not immune from current valuation of its assets, and closure when its capital reserves became inadequate. The total cost of Drexel to the SEC, SIPC and the U.S. taxpayers was zero. This compares reasonably well with the estimated $2.3 billion loss to the FDIC from the BNE, and several hundred million from NBW. Importantly, the customers of Drexel's brokerage firm did not suffer losses as a result of the firm's failure.

Our policy on capital adequacy could perhaps be said to resemble that of the Queen of Hearts: "Off with their heads!" That sounds harsh, but it is the only way we know to make sure that firms control their own risks, and stay well clear of the minimum requirements. While our policy is very strict, the traditional approach of the federal S&L regulators could be said to resemble a famous comic book saying: "Keep on Truckin." This approach has contributed to the continuing problem of overcapacity in the system.

One result of overcapacity and massive loan losses has been a very high rate of failures. Only 116 banks failed in the 40s, 46 in the 50s, 57 in the 60s, and 81 in the 70s. However, since 1980, over 2,000 banks and thrifts have failed, with losses that have strained the capacity of the FDIC. Indeed, the size of the FDIC's reserves as a percentage of insured deposits is now by far the lowest in history.

Perhaps a bit more discipline in the form of accurate accounting, strict capital requirements and early intervention would be a better approach than traditional federal banking regulatory policies, that, coupled with the deposit insurance system, have systematically shielded bank management from market accountability for poor performance.

U.S. financial markets play a vital role in our economy. Sadly, our system has grown more and more brittle over the years. Inflexibility, unnecessary costs and inefficiencies combined with adverse incentives and other damaging factors to produce a wave of loan losses of unprecedented dimensions. Public confidence in our system as a whole has been weakened. Many strong institutions remain, yet the overall system is not moving in the direction of greater stability and strength. Some will react to these trends by saying that "now is not the time to make changes while our system is weak". (That's a bit like someone saying "now is not the time to call a different play" after running the same play for 50 years and not making any first downs.) Others will say, "that is not my problem, so why should I worry about it?"

I have great optimism that the U.S. financial markets and their related private firms can remain the strongest in the world. However, that will not happen by accident. Personally, I do not believe that we can afford the luxury of doing nothing.

When your boat has a leak you fix it, you spend your life bailing, or you sink. Why is a system that employs 2 million people, accounts for more than 10% of GNP, and that is far less stable or efficient than it can be, not worth our effort? I believe that the coming debate this year in the Congress on these subjects will be an enormous opportunity to begin moving in the right direction. This debate has a chance of providing a "defining moment" for our financial system, and we should seize that moment and move to promote our own economic security right here at home.

The responsibility for reform rests in part with the federal and state governments. The responsibility for reform also rests, however, here, with the private bar and the private sector. We in Washington need your suggestions and support as we review and revise our laws and policies. Every agency and every group needs to consider not only its traditional parochial interests, but also and above all the national interest in a strong national financial system. If we work together towards this national goal, the American financial system will keep and increase its strength, vitality and flexibility, the qualities which have made it a model for all the world.

Thank you very much.