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Remarks by

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Good morning, and thank you for asking me to join you once again. Forums like these are an opportunity -- not only to meet with some of this state's leading bankers -- but to get away from day-to-day business and think more broadly about the trends affecting the banking industry.

Banking has been much in the news in recent years -- so much so, it seems, that even my friends outside the financial services industry are cocktail-party conversant about subjects such as Glass-Steagall and industry consolidation. And what's really interesting is that they often initiate the discussion. I think that's a reflection of the fact that one can hardly pick up a newspaper or turn on a television news show without being hit with a story about the issues you and I track every day -- from legislative proposals and counter proposals to the continued evolution of electronic commerce.

Last week, of course, the big news in banking circles was the announcement by the chairman of the House Banking Committee that he would no longer seek a comprehensive financial modernization bill in this session of Congress. It's no secret Chairman Leach and I have not always agreed on the best way to change the laws to bring about modernization of the banking and financial services industry. But we do agree on the broader issue that banks must be allowed to compete more equitably in the nation's changing financial services industry.

And, as Chairman Leach said last week, "... let there be no misunderstanding, the market place will ensure that the broader issues will not go away."

The fact is the business of banking has already changed dramatically in the past few years -- largely in response to market forces. And the marketplace will continue to move the industry in new directions -- raising new issues for bankers, policy makers and regulators alike. Despite our recent obsession with each day's headlines, the truth is that what's going on in the marketplace is the real financial modernization.

This morning, I'd like to look beyond those headlines and

reflect upon the fundamental changes that have occurred in the 1990s ... changes in bank products and services, in the sources of bank earnings and the composition of bank liabilities, even in the size and structure of banks themselves.

Let me turn first to bank products and services. Few outside the banking industry, I believe, fully realize exactly how much banks have diversified their product lines over the past decade.

Residential real estate: In 1985, only 8.6 percent of bank assets were in residential real estate. A decade later, residential real estate assets had nearly tripled to 23.2 percent. Mortgage backed securities account for over half of that increase, as banks have taken great advantage of a secondary market and a product that didn't exist ten years ago.

Consumer lending: Nearly 27 percent of bank lending today is made up of loans to consumers, up from 18 percent in 1985. In addition to increases in home mortgage lending, this also includes the expansion of credit card operations, installment loans, and home equity business. C&I lending, by contrast, has dropped 5 percent from a decade ago.

Insurance sales: According to the Association of Banks-in-Insurance, nearly 4100 commercial banks are selling insurance to consumers today. They also estimate that in 1994, sales of annuities alone generated over $1 billion of commissions and fee income for commercial banks. Other lines of bank insurance products -- including credit insurance, life/health/disability, and direct response -- accounted for another $1 billion of non-interest income for commercial banks.

Mutual fund sales: Banks began selling mutual funds and other securities products to their customers just over a decade ago, but in the last six years bank mutual fund sales have soared. Assets of mutual funds sold through banks more than quadrupled, growing from $86 billion in 1990 to almost $400 billion at year-end 1995. Over this same time period, mutual funds sold by banks grew from 8 percent to 14 percent of total mutual fund assets in the U.S.

The truth is that banks had little choice but to become involved in the mutual fund industry if they wanted to continue serving the financial needs of their customers. More and more Americans have moved their savings out of traditional bank deposits into mutual funds. By the end of the first quarter of this year, total mutual fund assets stood at about $3 trillion -- and they exceeded total commercial bank deposits. Indeed, if you look at the trend lines -- and the trends are continuing -- it seems almost certain that by the end of this year mutual fund assets will exceed the amount of assets in all deposit products, such as bank deposits, thrift deposits, and brokered deposits.

Parenthetically, let me add that given this sea change in where Americans prefer to put their savings, can you imagine how

banking would have been affected had we not allowed banks to engage in mutual fund activities?
Our actions were not universally popular at the time. But, how on earth can we expect banks to continue to be safe and sound and relevant financial services players, if we do not allow them to compete in what is clearly the most popular vehicle for consumer savings?

Not surprisingly, this change in the mix of bank products and services has resulted in a change in the composition of bank earnings. In the past ten years, non-interest income at national and state banks has increased 10 percent, accounting for 35 percent of bank operating revenues today. Much of this non-interest income was derived from fees for new bank products and services. For example, in the first quarter of this year, national and state banks sold $227 billion in mutual funds and annuities, an increase of 88 percent over the last two years.

Off-balance sheet activities also made a significant contribution to bank non-interest income. Last year, national and state banks supported $17.2 trillion in derivatives, compared to $6.2 trillion at the beginning of 1990. According to our most recent call report data, nearly 550 banks hold derivatives. First quarter 96 figures recorded derivatives activity of $17.8 trillion -- an all-time high -- with trading revenues of $2 billion.

This increase in non-interest income, as well as changes in the way banks manage their assets and liabilities, may account for a significant change in one of the traditional assumptions about bank earnings. According to conventional wisdom, a flattened yield curve almost inevitably meant a decline in bank earnings. That may no longer be the case. In 1991 and 1992, when we were coming out of the last recession, the yield curve steepened considerably. That was the normal pattern. Bank profitability paralleled that upward track, remaining strong through 1992 and 1993, as the yield curve stayed steep.

One school of analysts held that the record profits posted during those years were due almost solely to the steepness of the yield curve. These observers suggested that bank profitability would diminish once the curve flattened out, as it did in 1995. But bank profits have continued at record high levels. In short, what was previously viewed as a banking axiom -- the linkage between the yield curve and a bank's bottom line -- is not nearly so clear today as it was only a few short years ago.

Moreover, it should be noted that the weakening of the linkage between the yield curve and a bank's bottom line is somewhat mirrored in what appears to be a weakening of the linkage between the yield curve and a bank's net interest margin. Here again it would have been axiomatic just a few years ago that when the yield curve flattens, banking's net interest margin would flatten. But this is less clear today -- less clear, because of very significant changes in the liability side of banking's balance sheet.

The fundamental changes on the asset side of balance sheets that we have seen over the last several years are mirrored by changes on the liability side. A combination of consumer preferences and the development of new tools in the area of liability management has meant that banks have come to rely increasingly on purchased liabilities to fund their activities.

In 1985, 78 percent of bank assets were funded by traditional bank deposits. That has declined 8 percent in the last decade. More indicative of the trend, however, is the fact that banks' core deposits -- including traditional retail products such as savings and NOW accounts -- have declined nearly 10 percent in the last three years.

If market forces have altered the makeup of bank products, services, and sources of funding, they have also helped transform the structure of the U.S. banking system. An increasingly mobile population and businesses with nationwide operations increased the pressure to erase the artificial geographic demarcations in the delivery systems for bank services. Together with market pressure on banks to cut costs and increase efficiency, these forces have worked to transform U.S. banking, altering the number and size of its institutions.

Over the past six years, industry consolidation and mergers have increased markedly. While this trend began in the 1980s, it has accelerated in recent years, with legislative changes making it possible to centralize operations across state lines and with competitive pressures to do so increasing. Between 1986 and 1990, for example, the number of national banks declined on average by 409 banks a year, or roughly 3 percent annually. Between 1991 and 1995 -- as the number of national banks declined to about 2,900 -- we saw an average loss of 475 banks a year, or a 4.2 percent annual decline. As a result, today's average national bank is almost three times the size of the average national bank a decade ago.

In many respects, the legislation that permitted banks to consolidate their interstate operations under a single charter was essentially a ratification of something that had already occurred in banking in response to market forces -- the elimination of geographic barriers to bank operations. And now market forces, combined with technological advances, show signs of having a similar impact on the mechanisms through which banks deliver their diverse products and services. Even after stripping away all the hype about commerce on the Internet and cybercash, there is no denying that computers and electronic distribution networks are likely to become a common mechanism for delivering many banking services in the future. Computers have already altered -- and will continue to affect -- the way banks market their products and serve their customers.

It's projected that by the end of the decade, over 7500 banks will have a presence on the World Wide Web. How will that revolutionize banking and broaden its reach? More and more Americans are buying personal computers -- last year alone, the number of American homes with personal computers rose 16 percent, with much of that increase coming from older and less-affluent Americans. That by itself would be interesting but not immediately relevant to banking, except for the fact that today's computer users don't just use their PCs for word processing or playing games -- they use them to tie into computerized networks and on-line services.

According to Ray Smith, chairman of Bell Atlantic, by the end of the 1990s, as many as 50 percent of all homes in the U.S. will have a second phone line to handle their personal computer modem and fax needs. With banks just a web site away, these new lines represent a potential of over 50 million new points of sale for bank products. Already, banks are using web sites on the Internet to advertise products and services and sign up

new customers. That potential will only increase as other emerging technologies take root.

The sum of all these numbers and interesting statistics is this: today's banks are fundamentally different from their predecessors of 15 or 20 years ago. That is much more than an interesting footnote in the history of American finance. All of these changes in the business of banking and the market's continued pressure on banking to change even more have yielded very real benefits for the industry, the consumer, and the national economy.

The nation's banks have recorded four consecutive years of record profits, and figures for the first quarter of 1996 -- while not a quarterly record -- are certainly quite strong. This good health has been widespread, with fewer differences of performance between geographic regions or between banks of different sizes than at any time in the 1980s. Last year, the number of unprofitable national banks fell to just 95, or 3.3 percent of all national banks. That compares to nearly 19.7 percent a decade ago.

These years of record profits have coincided with years of improved service to bank customers. Mortgage loans to low- and moderate-income homebuyers have increased dramatically over the past several years. And consumers today enjoy the benefits of a more competitive financial services marketplace. For example, today Americans in more than half the states in the U.S. can choose whether to buy insurance from their local banks, insurance agents, or directly from insurance companies. If they want to diversify their savings, they have the opportunity to buy annuities and mutual funds from their local banks. In many cases, these bank purchasers of mutual funds have not traditionally taken advantage of the opportunity to buy investment products.

Research conducted jointly by the OCC and the SEC shows that bank purchasers of mutual funds tend to be recent entrants to the world of investing. By providing an opportunity for them to earn higher returns and -- at the same time -- channel their funds into productive investments, banks have made an important contribution to the nation's continued economic growth.

These results are remarkable indeed. But as a bank supervisor, I would be remiss if I did not point out a few dark spots in this otherwise rosy picture of a transformed banking industry.

There is a plausible argument to be made that a banking industry increasingly dependent on fee income may be less vulnerable to the traditional business cycle. But there is much we don't yet understand about how a weaker economy might affect fee income in the future. The fundamental changes in the banking industry mean that future downturns could generate unforeseen results.

A regulator's job is to ask questions -- particularly when it appears that everything is going well. Questions such as:

How will today's asset and liability management strategies weather economic changes? And how will banks' new sources of revenue be affected when interest rates change or credit problems arise? While a great deal has changed in banking, some things have not -- particularly the need to focus on the fundamentals of sound risk management. The increase in banks' retail loan portfolios makes banks more vulnerable to problems in the retail sector, so there is concern when we see rising delinquencies and an increase in noncurrent loans. Noncurrent loans grew by $659 million in the first quarter of 96, and -- while this is only the second quarterly increase in the last five years -- it is nonetheless cause for concern.

Further, last week the American Bankers Association reported that credit card delinquencies reached a 15-year high in the first quarter, and data released by the Federal Reserve showed that credit card debt rose at a 20 percent annual rate in April. As one analyst observed, that means that debt is growing three times faster than incomes.

The OCC's National Credit Committee is now conducting its second survey of national banks' underwriting practices, and we're focusing particularly on banks' retail loan portfolios. We expect to be able to share the results of that survey in August.

These are real problems that neither regulators nor the banking industry can ignore. But they should not detract from my central point here today. The fact remains that the banking industry today is fundamentally sound, and it is a fundamentally different industry from what it was only a decade ago -- not because of actions taken by Congress or state legislatures, but because of actions the industry itself has taken in response to market forces.

In that connection, I would like to leave you with three final observations about modernizing the financial services industry.

First, the inability to achieve financial modernization legislation this year should not distract us from what America's financial services industry has already achieved and enjoys -- broad and deep capital markets, access to new technology and the ability to employ it effectively to reach new markets, a regulatory community focused on risk and reducing burden, a highly skilled financial services workforce, and knowledgeable consumers who demand the benefits of competition and challenge you to stay on the cutting edge of innovation and invention. Too often, I'm afraid, we get so caught up in what we'd like the industry to become that we fail to appreciate what an incredible asset it is for our country and what its vitality means for America's ability to compete in the global marketplace.

It's also a testament to the industry's fortitude to have achieved what it has while operating under an outmoded and overly restrictive set of laws and regulations.

Second, the transformation that has already occurred in the financial services industry has little to do with the debate that occurred on Capitol Hill and in state legislatures -- this year and for the past 20 years -- under the rubric of "financial modernization."

The real financial modernization has occurred in the marketplace.

That brings me to my final observation. What we need from our legislatures is much more than an exercise in allocating turf among competing interests or industries. Trying to carve up the financial services marketplace is a little like what the great powers tried to do in carving up Europe at Yalta at the end of World War II.

Not only is a Yalta-like agreement hard to achieve, in the long run it doesn't work.

Rewriting the laws that govern banking and financial services must be based on fundamental principles -- principles that respect rather than fight the market forces that are reshaping the banking industry. We need to reach consensus on the guiding principles for true modernization of the legal and regulatory framework that will govern our financial institutions in the 21st century.

In fact, the OCC and the Administration are working now to develop the principles that we believe should guide us in this arena, and we intend to work from those principles to develop a specific understanding of the changes in law, regulation and supervisory practice that would be required for their implementation.

We cannot develop those principles in a vacuum, however. We need your input. With industry, regulatory and bipartisan support, I believe all of us can achieve a broader, more contemporary, market-based approach to rewriting the laws that govern the workings of our nation's financial system. Working together, I'm confident we can and will continue to build a stronger banking system better able to meet the financial needs of its customers in the years to come.

I am committed to achieving this more modern framework. I know you are. And, I am confident that working together we can achieve true, broad-based financial modernization that will serve America's consumers and our national economy even better than the system we have today.

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