Restructuring the Financial System: Summary of the Bank's 1987 Symposium

By Gordon H. Sellon, Jr.

For some time there has been a growing feeling by financial market participants, regulators, and congressional leaders that substantial reform of financial market regulation is overdue. Indeed, there is widespread consensus that the regulatory framework inherited from the depths of the financial crisis of the 1930s is no longer adequate in the high-tech, global financial marketplace of today.

The stimulus for financial reform comes from many directions. Most apparent are the various crises that have struck financial markets in recent years. Events such as the problems of the thrift industry, the increase in bank failures, the impact of LDC debt, and the recent stock market crash have aroused widespread concern. More subtle, perhaps, but no less important are longer term trends such as the erosion of traditional roles of financial institutions, the development of new and esoteric types of financial instruments, and the globalization of world financial markets.

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The need for financial reform has led Congress to move these issues to the front of the legislative agenda. Thus, the Competitive Equality Banking Act of 1987 attempted to address the solvency problems of the thrift industry while placing a moratorium on new activities of banks and other financial institutions. Recently introduced legislation goes further toward a restructuring of the financial services industry.

In order to more fully examine the issues involved in financial reform and the policy alternatives, the Federal Reserve Bank of Kansas City sponsored a symposium entitled "Restructuring the Financial System" held at Jackson Hole, Wyoming, on August 20-22, 1987. At this conference, distinguished academics, regulators, and financial industry representatives discussed the need for financial reform and debated the merits of various proposals for restructuring the financial system.

This article highlights the issues raised at the symposium and summarizes the papers and commentary. The first section of the article provides an introduction to the main issues and themes raised at the symposium. The following four sections summarize the viewpoints of the program participants and their policy recommendations.

Introduction

Symposium participants expressed a strong consensus on the need for financial restructuring and their identification of the factors undermining the current regulatory framework. There was also general agreement that the focus of reform should be on the banking industry and its linkages to other financial and nonfinancial firms. Specific areas of agreement were the desirability of expanding bank powers to include securities activities and reform of the deposit insurance system.

Significant differences among program participants emerged, however, with regard to the extent of linkages between banks and other firms, the form these linkages should take, and the way a revised financial industry should be supervised and regulated. Thus, in contrast to the general agreement over the expansion of bank securities powers, there was sharp disagreement over the desirability of linkages between banks and nonfinancial firms.

As background to an understanding of the issues raised in the symposium papers, the remainder of this section focuses on two topics: the rationale for financial restructuring, and a summary of the principal points of contention among program participants.

The rationale for financial reform

A number of symposium participants discussed the evolution of financial markets and the rationale for financial restructuring. The paper by Thomas Huertas provided a particularly useful description of how the current financial regulatory framework evolved from the financial turmoil of the Great Depression. In his view, the regulatory framework set up in the 1930s was designed to provide financial stability by establishing a system of cartel finance. Within this structure, financial institutions were divided into three groups: deposit banking (consisting of commercial banks and thrift institutions), investment banking, and insurance. By the use of laws regulating the degree of competition both within and between these groups of financial institutions, their profitability could be maintained and the safety and soundness of the financial system ensured.

Over time, economic forces and technological advances undermined the basis of this system by reducing the profitability of some types of institutions, causing them to press for expanded powers and activities, while raising the profitability of other institutions, making their business more attractive to the less profitable institutions. Moreover, the growing global linkages of financial markets introduced an added dimension of competition, making international differences in financial regulation a further stimulus to reform.

As a result of these pressures, barriers to the affiliation between investment banking and insurance have been removed and distinctions between commercial banks and thrift institutions have largely disappeared. Thus, the key barriers remaining are those governing the association between depository institutions and other financial and nonfinancial firms. The principal laws regulating these linkages are the Glass-Steagall Act, which restricts member banks' affiliation with firms involved in securities underwriting, and the Bank Holding Company Act, which regulates the association of banks with other financial and nonfinancial firms.

Much of the recent debate over financial restructuring has revolved around the interpretation of these laws. Thus, banks have pressed for expanded underwriting powers through creative interpretations of the Glass-Steagall Act while nonbank financial and nonfinancial firms have attempted to gain banking powers through the socalled nonbank-bank loophole in the Bank Holding Company Act.

Issues in the restructuring debate

While symposium participants generally agreed that financial reform is necessary and that, at the minimum, the Glass-Steagall Act should be changed or eliminated, there was considerable disagreement over the extent of permissible linkages between banks and other financial and nonfinancial firms. Participants also differed on the methods and effectiveness of insulating banks from the risks of new activities, on the implications of restructuring for competition, and on the role of supervision and regulation in a restructured financial system.

Symposium participants favoring expanded linkages between banks and other financial and nonfinancial firms advanced a number of points in support of this position. Some argued that banks cannot compete effectively in the current regulatory environment. They cited the increase in securitization, that is, the increase in direct lending in credit markets at the expense of bank lending, and the declining trend in bank profitability in recent years. In this view, allowing banks to diversify into activities such as underwriting and other investment banking activities may expand bank profitability and enhance the stability of the banking system. Other participants argued that there are cost advantages in the form of economies of scope in allowing banks to associate with other financial and nonfinancial firms. That is, synergies in the joint production of financial services or in the joint production of financial and nonfinancial services might result in increased economic efficiency and lower costs to the consumer. Finally, some argued that many of the reasons for protecting banks that were important in the 1930s are no longer relevant.

In contrast, symposium participants advocating more limited linkages between banks and other firms generally saw banks as continuing to play a special role in the economy that requires more protective regulation of banks. In this view, banks play an important role in the payments system, as a source of liquidity, and in the transmission of monetary policy. Banks are also viewed as special because of their connection to the federal safety net—deposit insurance and the Federal Reserve discount window. To some participants, expanded linkages between banks and other firms raise the possibility of the extension of the safety net to these firms. This is seen as undesirable either because of the greater potential exposure of the insurance funds or taxpayers to the financial problems of these firms or because of the competitive advantage that the implicit subsidy of the safety net provides these firms.

The possibility of expanded linkages between banks and other firms raised another important symposium issue, the question of whether banks can be insulated from the problems of affiliated firms and how insulation might be accomplished. While there was general agreement that some insulation of banking was necessary, there was less agreement on the appropriate form of insulation and its effectiveness. A distinction made by some participants involved the placing of new activities in bank subsidiaries versus holding company affiliates. Many of the restructuring proposals discussed at the symposium emphasized the use of a financial services holding company which could own both a bank and other financial firms. Some participants argued that the holding company form would allow better insulation than if expanded activities were to be carried out in bank subsidiaries. Other participants focused on the types of regulations necessary to prevent conflicts of interest and abuses of the federal safety net. While some symposium participants thought that insulation was feasible, others were clearly skeptical that effective insulation was possible or that insulation was compatible with banks taking advantage of synergies with other firms.

Symposium participants also held widely differing views as to the competitive effects of restructuring. Some argued that the existing regulatory structure was anticompetitive and that proposed changes in the regulatory structure would promote competition and reduce the costs of financial services. In contrast, others were concerned with the possibility of increased concentration of economic power if a revised regulatory structure permitted the development of large financial and commercial conglomerates.

A final issue discussed by many of the program participants was the question of how a restructured financial system should be regulated and supervised. Many advocated the use of functional supervision and regulation, where each part of the holding company would be supervised by its appropriate regulatory agency. Symposium participants expressed differing views, however, as to whether there should be consolidated supervision, that is, supervision of the parent holding company in addition to the functional supervision of its component parts. There were also differences of opinion as to the responsibilities of the Federal Reserve, Federal Deposit Insurance Corporation, and Comptroller of the Currency in a revised financial structure. A number of participants stressed the desirability of international coordination of financial regulation, noting that the recent U.S.-U.K. accord on capital standards was but a first step in the right direction.

The need for financial restructuring

Presentations by Franklin Edwards and Robert Eisenbeis examined the problems with the current structure of financial regulation and the need for financial reform. Both authors argued that the current system of financial regulation is outdated and that significant changes are necessary to ensure a safe and efficient financial system. The authors emphasized that the first steps toward financial restructuring involve a re-examination of the goals of financial regulation as well as the premises or myths underlying the current regulatory system.

The crisis in the financial system

In "Can Regulatory Reform Prevent the Impending Disaster in Financial Markets," Franklin Edwards presented a picture of a seriously flawed system of financial regulation, mired in recurring crises and riddled with inconsistencies. In his view, powerful economic and technological changes will continue to undermine and weaken the existing regulatory system. Policymakers can either take the initiative and orchestrate financial change by redesigning the regulatory framework or ignore the growing problems and suffer the consequences.

In Edwards' view, the time has come to reach a consensus on the future of the financial system and to establish a compatible regulatory framework. He identified two important steps in this process. The first step is to dispose of harmful myths that have been obstacles to financial reform. The second step is to agree on the fundamental goals of financial regulation and the nature of government intervention to achieve these goals.

A restructured financial system should have a number of features according to Edwards. First, deposit insurance should be restricted to protecting small depositors so as to minimize moral hazard problems. Second, the Federal Reserve in its role as lender-of-last-resort should be the chief protection against bank runs and systemic risk problems. Third, barriers to competition should be removed and financial institutions should be permitted to undertake a wide range of financial activities. Fourth, antitrust laws should be the primary method of preventing unfair competitive behavior. Fifth, financial institutions should be subject to greater market discipline by the use of market-value accounting and public disclosure. Finally, regulation to protect the safety and soundness of the financial system should be backed by minimum capital requirements and a timely closure policy. In Edwards' opinion, these features would form the centerpiece of a restructured financial system.

Rethinking the premises of financial regulation

In "Eroding Market Imperfections: Implications for Financial Intermediaries, the Payments System, and Regulatory Reform," Robert Eisenbeis examined the premises that underlie current financial regulation and analyzed their relevance in a restructured financial system. He argued that the forces of economic and technological change and the process of deregulation have altered the fundamental roles of financial intermediaries and the mechanics of the payments system. Thus, in his opinion, any restructuring proposals must be based on new premises about the roles of financial institutions and government regulation.

Eisenbeis identified three premises that, explicitly or implicitly, underlie the financial structure inherited from the 1930s. The first premise is that financial intermediaries have unique roles or functions in the financial system. The second premise is that the government's responsibility for ensuring the safety and soundness of the financial system requires special treatment of banks. The third premise is that domestic financial markets are insulated from international markets so that financial regulation is basically a domestic issue.

According to Eisenbeis, these premises are no longer valid and should not be used as the basis for a restructured financial system. The first premise is invalid because economic and technological changes and deregulation have eliminated most of the market imperfections that justify separate roles for financial intermediaries. Thus, according to Eisenbeis, there is no longer a strong case for sharply delineating the activities of financial institutions in a restructured financial system.

The second premise is invalid, Eisenbeis believes, because these same economic forces have reduced the role of banks and their deposit liabilities in the payments system. Since the bulk of payments system transactions now occur electronically, the key to maintaining payments system stability is to ensure the reliability of the flow of transactions through the payments system. According to Eisenbeis, the main risks to the payments system are intraday credit risks that can largely be eliminated through changes in payments system rules. Furthermore, since the protection of banks and their deposit liabilities is no longer central to protecting the payments system, there is little scope for deposit insurance. While deposit insurance might provide wealth protection to small depositors, Eisenbeis believes that the same result could be accomplished by other means.

Finally, given the growing linkages among international financial markets, it is no longer possible to base financial regulation exclusively on domestic considerations. Thus, Eisenbeis believes that any proposal to restructure the U.S. financial system must contain elements that allow harmonization with regulations abroad.

In his commentary on the Eisenbeis paper, Edward Kane emphasized the roles that regulators and political factors play in the financial system. While Eisenbeis discussed how regulatory taxes could distort the financial system, Kane argued that regulatory subsidies were also extremely harmful.

In Kane's view, many of the problems cited by Eisenbeis are less the product of economic and technological change than of inappropriate regulatory behavior. That is, regulators tend to subsidize inefficient or harmful behavior to defend their turf or to expand their political influence. According to Kane, they are able to do this because of the absence of correct information about the true extent of the subsidy and the real burden on taxpayers. Kane feels that meaningful reform of deposit insurance or elimination of payments system risk will occur only when regulators are forced to reveal the true cost of the subsidies or when their ability to extend subsidies is constrained.

Financial restructuring: the international experience

Financial reform issues are not confined to the United States. In Canada, the United Kingdom, and Japan, economic and technological changes have also tested the existing system of financial regulation and have been a stimulus to financial restructuring. The reform process is at different stages in these countries. In Canada, restructuring decisions have been made and are in the process of legislative enactment. In the United Kingdom, financial restructuring is largely completed. Japan, like the United States, is in the early stages of the reform process.

Financial reform in Canada

In "Financial Restructuring: The Canadian Experience," Charles Freedman described the recent process of financial reform in Canada. According to Freedman, financial regulation in Canada has been characterized historically by three themes: functional separation of financial institutions, separation between financial and commercial firms, and a tradition of widely held ownership of financial institutions. Responsibility for financial regulation in Canada is shared by the federal and provincial governments. Thus, for example, banking powers are determined at the federal level and most securities powers, at the provincial level.

In recent years, a number of developments have tended to undermine the traditional tenets of financial regulation in Canada. Increasingly, financial institutions have attempted to broaden the scope of their activities by moving into product areas of other financial institutions. Thus, the traditional compartmentalization of the financial system has broken down. In addition, large commercial firms have recently acquired trust companies and life insurance companies. This development has established commercial-financial industry linkages and has changed the ownership of portions of the financial services industry from widely to closely held. As a result, increased attention has been paid to potential problems of conflict of interest, self-dealing, and ownership concentration. Other factors giving an impetus to financial reform were failures of financial institutions which raised questions about the deposit insurance system, concerns about the competitiveness of Canadian institutions in international financial markets, and differing approaches to financial reform by federal and provincial regulators.

The financial restructuring proposal agreed to in Canada has several features. First, financial institutions in Canada are to receive greatly expanded powers. In particular, the Canadian equivalent of Glass-Steagall is to be abolished so that banks will be permitted to invest in securities subsidiaries and will be able to engage in certain securities-related activities directly. The expanded powers are subject to some restrictions, however. For example, large financial firms will not generally be permitted to purchase large financial firms in other areas except for securities dealers. Also, retailing of insurance is a power that is specifically excluded from the expanded rights to network.

A second feature of the restructuring approach concerns the ownership of financial institutions and commercial-financial linkages. Generally speaking, there is a desire to limit commercial-financial linkages and to encourage widely held ownership of financial institutions. Thus, no commercial links are permitted for banks, and large banks are required to be widely held. Other provisions apply to nonbank financial institutions so as to arrest the trend toward commercial linkages and to encourage widely held ownership. The Canadian approach also attempts to deal with potential conflict of interest and self-dealing problems by strengthening regulations governing transactions between affiliated firms and their owners, increasing consumer disclosure, and strengthening the role of directors and auditors of financial firms.

Financial reform in the United Kingdom

The process of financial restructuring in the United Kingdom was discussed by Anthony Loehnis in his paper, "Financial Restructuring: The U.K. Experience." According to Loehnis, there are important similarities and differences in comparing financial reform in the United Kingdom and other countries.

Like the United States and Canada, the financial structure in the United Kingdom has developed along functional lines with a great deal of product specialization. And, as in these other countries, the forces of economic and technological change have tended to erode these distinctions over time.

A distinguishing characteristic of the U.K. experience, however, is the relatively small role played by formal regulation and legislation and the relatively large role of supervision. For example, Loehnis noted that in the United Kingdom there has never been a formal definition of a bank or a formal list of financial activities appropriate to banking. Rather, bank activities and linkages with other firms are largely a matter of supervisory decisions. Thus, there is no equivalent of Glass-Steagall in the United Kingdom and merchant banks have traditionally played an important role in the issuance and underwriting of securities. Similarly, while there are no formal prohibitions against banking and commercial or insurance linkages, supervision has limited these linkages.

Two of the major financial restructuring issues that have been decided recently in the United Kingdom are the activities of building societies and the regulation of the London Stock Exchange. Restrictive legislation confining the activities of building societies to housing has been modified, and these institutions are now able to compete with banks in a number of areas. The widely publicized "Big Bang" liberalized regulations of the London Stock Exchange to allow banks and investment banks access to stock brokerage and marketmaking.

Loehnis observed that one of the principal results of these recent regulatory changes is a merging of the functions performed by firms in the banking and securities industry. Significant financial conglomerates that combine a wide variety of financial activities have emerged from this process. Thus, much attention has been focused on the difficult task of supervising these complex institutions. While generally embracing the concept of functional supervision applied to the component parts of these institutions, U.K. officials have decided that consolidated supervision by a "college of supervisors" is appropriate for the more complex organizations.

Finally, Loehnis emphasized the important role that international factors have played in the U.K. restructuring process. One of the principal motivations for "Big Bang" was to allow greater capitalization of U.K. securities firms and to expand the depth of the London stock market. More generally, Loehnis concluded that the greater integration of financial markets had increased the desirability of international coordination in the regulation of both banking and securities activities.

Financial reform in Japan

Financial restructuring developments in Japan were described by Yoshio Suzuki in his paper, "Financial Reform in Japan: Developments and

Prospects.'' While the pace of financial reform has been more gradual in Japan, important changes have occurred and more changes are likely in the future as the globalization of financial markets continues.

According to Suzuki, the Japanese financial system has important similarities and differences when compared with the systems in the United States, the United Kingdom, and Canada. As in these countries, Japan has historically-based, structural distinctions between types of financial institutions. Also, in Japan, economic and technological changes have put pressure on the barriers between financial institutions. In contrast to the other countries, however, Japan has had a higher degree of formal regulation of financial markets and institutions, and the process of financial restructuring has proceeded at a slower pace.

One area in which change has occurred in Japan is in the separation of banking and securities activities. In Japan, restrictions on banking and securities activities are governed by article 65 of the Securities and Exchange Law, which is similar to Glass-Steagall restrictions in the United States. In recent years, this law has been modified somewhat to permit banks to have greater scope in underwriting and dealing in public bonds while allowing securities firms to offer cash management accounts. Distinctions between banks and other types of financial institutions have also been relaxed somewhat in recent years, but a number of activity and powers restrictions remain.

According to Suzuki, linkages between banks and commercial firms are not currently an issue in Japan. Financial service holding companies are not permitted in Japan so that this organizational form cannot be used to establish these linkages. In addition, commercial firms cannot establish banking linkages through the use of nonbank banks as in the United States. Also, ownership of banks in Japan is broad based so that the purchase of a bank is difficult. At the same time, Suzuki noted that this issue will probably have to be addressed in the future. If so, he felt that the goal of maintaining payments system stability should be the guiding factor in permitting these linkages.

The two most important future financial reform issues, in Suzuki's opinion, are the harmonization of international financial regulation and the problem of payments system risk. While harmonization is crucial, Suzuki noted that its success will depend on the ability of countries to develop a greater mutual understanding of other countries' financial systems.

Proposals for financial restructuring

In the past year, the debate over financial restructuring has taken an important step forward. Instead of a focus on single issues such as deposit insurance reform or nonbank banks, a number of recent proposals attempt a comprehensive solution to a wide range of restructuring issues. The analysis of these proposals was a major objective of the symposium.

The FDIC restructuring proposal

In his luncheon address, ''Perspectives on Financial Restructuring,'' L. William Seidman outlined the FDIC's proposal for financial reform. Generally speaking, the FDIC approach envisions ''a relaxation of restraints on bank powers, ownership, and affiliates, while strengthening safety and soundness through supervision.''

The FDIC staff study on restructuring examined the historical role of banks in the U.S. financial system and the evolution of financial market regulation. This review generated three main conclusions. First, the changing structure of the U.S. financial system had diminished the role of banks and threatened financial stability. Second, the separation of banking and commerce had no inherent historical basis. Third, Glass-Steagall was an overreaction to the problems of commercial and investment banking linkages in the 1930s.

According to Seidman, the central question in the restructuring debate is whether an effective supervisory wall can be constructed around banks. If so, there is no need for direct supervision or regulation of bank owners or nonbank affiliates. The FDIC staff believes that this wall could be constructed and Seidman outlined the inventory of regulatory powers needed to accomplish this task. With banks protected, the FDIC study concluded that Glass-Steagall and much of the Bank Holding Company Act could be eliminated.

In summary, according to Seidman, the FDIC envisions a "system that keeps banks safe because they are special but lets the marketplace around them operate with freedom from bank regulators."

A comparison of restructuring proposals

In "Redesigning Regulation, the Future of Finance in the United States," Thomas Huertas provided a critical appraisal of several of the recent reform proposals.[1] In his view, the central issue in the structuring debate is how the affiliations between banks and nonbanks should be regulated.

The restructuring proposals discussed by Huertas have a number of similarities and some important differences. All are similar in that they focus on bank affiliation, and all focus on corporate affiliation rather than who controls banks. Since all proposals allow banks to have financial affiliates, changes are envisioned in the Glass-Steagall and Bank Holding Company acts. Finally, all of the proposals considered are optional and place reliance on functional regulation of the bank and its affiliates.

The restructuring proposals differ in two respects. One set of proposals advocates consolidated supervision of the entity owning the bank and prohibits bank affiliation with commercial firms. The other set of proposals believes that consolidated supervision is unnecessary and allows bank-commercial links.

Huertas argued that these differences can be traced to different views on three issues: whether banks can be insulated from their affiliates, whether the federal safety net extends to bank owners or affiliates, and whether financial-commercial linkages would lead to economic concentration. According to Huertas, advocates of the first set of proposals emphasize difficulties in insulating banks from affiliates, feel that the safety net extends to affiliates, and believe that banking-commercial linkages will lead to excess concentration of economic power. In contrast, proponents of the second set of restructuring plans believe that insulation is possible, that extension of the safety net can be controlled, and that increased competition and economic efficiency will result from the affiliation of banks and other firms.

Huertas provided a detailed analysis of the insulation, safety net, and concentration issues and concluded that the second restructuring approach is preferable. Thus, he felt that financial restructuring should be based on the principles of protecting the bank via insulation rather than consolidated supervision, and allowing free affiliation of banks with other financial and nonfinancial firms.

Another view of financial restructuring

In his paper, "The Case for Preserving Regulatory Distinctions," James Tobin argued that protection of the system of monetary payments should have priority over expanded bank activities. In Tobin's view, the urgent problems in financial restructuring are the abuse of

[1] The proposals discussed are those by Gerald Corrigan, Robert Heller, the Office of the Comptroller of the Currency, the Association of Bank Holding Companies, and the Association of Reserve City Bankers.

deposit insurance and the extension of the federal safety net. Reform of the deposit insurance system is difficult, however, as risk-based deposit insurance is impractical.

As an alternative approach, Tobin proposed restructuring the monetary and depository system to reduce the reliance placed on deposit insurance. His proposal has two parts. First, he suggests the creation of a kind of deposit money so safe that it does not require insurance. This "deposited currency" could be provided by the Federal Reserve or banks. To the extent banks offered this deposit, they would have to separate these funds from other liabilities and invest them in eligible assets such as federal funds or short-term Treasury bills. Because these deposits would not have to be insured against liquidity or solvency problems, a large part of the payments system would be protected without deposit insurance.

The second part of Tobin's proposal involves a redefinition of a commercial bank. A "commercial bank" would be confined to holding liabilities eligible for deposit insurance. These "commercial banks" would have asset portfolios consisting of relatively short-term assets including government securities and commercial loans. They could not hold long-term, fixed-rate assets or speculate in currency or securities markets. These new "commercial banks" would have high capital requirements. Deposits in any institutions other than these "commercial banks" would be uninsured.

On the question of expanded powers for banks, Tobin supported only limited changes, to be effective only after the safety net issues are resolved. He was generally skeptical about the case for wholesale deregulation, arguing that there was little evidence of synergies in expanded linkages or that new activities would be risk-reducing. He would allow banks to have an investment banking affiliate with uninsured liabilities and, perhaps, an underwriting affiliate provided that capital and regulatory restrictions protected the bank. However, banks would not be permitted to have commercial affiliates.

Commentary on financial restructuring

In his discussion of the Huertas and Tobin papers, Robert Litan raised concerns about the corporate form in which expanded bank activities might occur. He thought that a likely restructuring scenario might involve states taking the lead as they have done for interstate banking. If so, Litan expressed his concern that expanded bank activities would be more likely to occur directly out of the bank or through a bank subsidiary. Two problems with this approach are that bank capital could be directly impaired by new activities and that the lines of regulatory authority could be unclear. Thus, Litan preferred the holding company form of affiliation.

Litan was critical of Huertas' discussion of insulation. In general, Litan felt that Huertas placed too much faith in the ability of supervision and regulation to minimize the dangers of new bank activities. Litan also questioned whether this approach could result in overregulation that could eliminate the scope economies of diversification.

According to Litan, a "narrow banking" approach to insulation was preferable. In this view, in exchange for broader powers, a holding company would have to confine the activities of its insured institutions to accepting deposits and investing the proceeds in safe, liquid assets. These narrow banks would not be allowed to make loans, and only narrow banks would have access to the payments system.

Litan contrasted his approach to Tobin's. According to Litan, his approach was designed to permit banks more product line freedom while reducing risk, while Tobin was mainly concerned with correcting problems with deposit insurance. Litan also viewed his proposal as less radical than Tobin's because the Tobin approach would apply to all banks, not just those in a diversified organization. In contrast, the Litan approach is optional, only applying to those institutions wanting to diversify into other activities. Finally, Litan noted that Tobin was concerned with interest rate risk rather than credit risk. Thus, the asset portfolio of Tobin's "commercial bank" is restricted to short-term assets including commercial loans. Litan was more concerned about credit risk and so would not permit "narrow" banks to make loans.

In his discussion of the Huertas and Tobin papers, Steven Roberts argued that greater attention needed to be paid to the goals of financial regulation. While many of the symposium participants identified a set of goals, Roberts sensed a lack of consensus on a basic set of objectives.

Roberts agreed with Tobin as to the priority of addressing the problems with the federal safety net before proceeding with any broad restructuring of the financial services industry. He expressed particular concern with the prospects of mixing banking and commerce until the safety net issues were resolved.

Noting that the reduction of statutory barriers to the mixing of financial activities placed a heavier burden on regulation and supervision, Roberts raised a number of potential problems. He was also critical of reliance on functional regulation, urging the necessity of having a financial overseer who would be independent of the industries regulated. While commenting favorably on the comprehensive nature of Huertas' discussion of insulation, Roberts expressed pessimism that Congress would give regulatory authorities the necessary powers to insulate effectively. In general, he felt that the answer to the insulation issue lay between the procedures outlined by Huertas and the outright prohibitions of Tobin.

Symposium overview

Three participants—Henry Kaufman, Carter Golembe, and Gerald Corrigan—provided an overview and summary of the issues raised at the symposium. While all three stressed the need for financial reform, they offered different perspectives on the problem of financial restructuring.

Henry Kaufman strongly agreed with the view that financial innovations and technological changes had seriously weakened the financial system. While rejecting a return to the strict compartmentalized regulation of the past, Kaufman expressed serious reservations about wholesale deregulation. In his view, financial institutions played a special role in the economy that required special regulatory treatment.

According to Kaufman, three principles should form the basis of financial reform. First, because of the fiduciary role of financial institutions, their role in the payments and credit allocation mechanisms, and the dangers of extension of the federal safety net, financial and commercial firms should be kept separate. Second, to avoid conflict of interest problems, financial institutions should not be permitted to be lenders and equity investors. In Kaufman's opinion, the regulatory structure should separate the functions of lending, underwriting, and equity investment. Third, deposit insurance should be used to strengthen the financial system by requiring that insured deposits be invested in creditworthy assets.

Kaufman also proposed two changes in the structure of supervision and regulation. First, he suggested an official central authority be established to oversee financial markets and institutions. This authority would establish capital, reporting, and disclosure requirements and would replace the current system of overlapping regulatory authority. Second, an official international agency should be set up to ensure consistency of international supervision and regulation.

In reflecting on the many restructuring issues discussed at the symposium, Carter Golembe emphasized the urgent need for reform of deposit insurance and the federal safety net. He felt that the most logical reform, returning deposit insurance to a limited purpose, social welfare objective, was politically infeasible. He also agreed with the proposition advanced by a number of participants that no bank should be too big to fail. Golembe argued that if there was a public interest in preventing the failure of a large bank, the FDIC's responsibility should be limited to its explicit insurance commitment.

Golembe generally favored an expansion of bank powers and activities. On the question of the institutional structure used to insulate a bank from the risks of other activities, Golembe found merit in both the "narrow bank" approach and the concept of a financial services holding company. Both approaches were attractive to him because they addressed the problem of deposit insurance reform. He felt, however, that the holding company approach was more feasible.

Golembe also discussed the slow progress of financial restructuring. In his opinion, financial reform had been slowed by Congress, the banking industry, and the Federal Reserve. He thought that Congress generally preferred to delegate decisions on financial issues to regulators rather than referee turf battles between special interest groups. At the same time, he felt that the Federal Reserve was reluctant to push politically charged restructuring issues for fear of losing its ability to conduct an independent monetary policy. Finally, Golembe thought that the banking system as a whole was not supportive of restructuring because the majority of bankers were not interested in Glass-Steagall issues.

In his closing commentary on issues raised at the symposium, Gerald Corrigan emphasized the importance of limiting systemic risk. He stressed that a key objective of financial regulation should be the protection of the financial system as a whole against the possibility of destabilizing accidents. He believed that the complexity of this task had increased with the increased interdependencies of financial markets.

According to Corrigan, the primary difference of opinion at the symposium concerned the separation of banking and commerce. He felt that the answer to this question depended on a balancing of the economic benefits of those linkages against the risks. In Corrigan's view, legitimate arguments in favor of banking and commercial linkages would be based on a lack of competition in banking, economies of scale, or a shortage of capital in banking. The risks of such linkages were both historical concerns such as conflicts of interest and concentration and concerns about extension of the federal safety net. In Corrigan's opinion, there was no strong evidence that banking and commercial linkages have significant economic benefits. He was also skeptical that banking could be effectively insulated. Thus, he concluded that the risks of merging banking with commerce outweighed the benefits.