Introduction

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

The stimulus for financial reform comes from many directions. Most apparent are the various crises that have struck financial markets in recent years. Such events as the problems of the thrift industry, the increase in bank failures, the impact of lesser developed country 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.

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 of new activities of banks and other financial institutions. Recently introduced legislation goes further and contains several proposals for restructuring the financial services industry.

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To promote a better understanding of 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" on August 20-22, 1987. At this conference, distinguished academics, regulators, and financial industry representatives examined the need for financial reform and debated the merits of various proposals for restructuring the financial system.

Symposium participants expressed a strong consensus on the need for financial restructuring and the factors undermining the current regulatory framework. There also was general agreement that reform should focus on banking 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 reforming the deposit insurance system.

Significant differences among participants emerged regarding the extent of linkages between banks and other firms, the form that 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 for understanding the issues raised at the symposium, the remainder of this introduction focuses on two topics: the need for financial restructuring and a summary of the principal points of contention among program participants.

The need 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 provides a particularly useful description of how the current financial regulatory framework evolved from the financial turmoil of the Great Depression. In this 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: those providing deposit banking (commercial banks and thrift institutions), investment banking, and insurance. By using laws regulating the

degree of competition both within and between 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 bash 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 were removed and distinctions between commercial banks and thrift institutions largely disappeared. 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 affiliation of member banks 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 sought to gain banking powers through the so-called "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 their position. Some argued that banks cannot compete effectively in the current regulatory environment. These participants cited the increase in securitization—the increase in direct lending in credit markets at the expense of bank lending—and the declining trend in bank profitability in recent years. It was felt that allowing banks to diversify into such activities as underwriting and other investment banking activities might increase 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 increase 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 also are 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. Such an extension 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 to 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, if so, 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. Some participants made a distinction between the appropriateness and effectiveness of placing new activities in bank subsidiaries

and placing them in holding company affiliates. Many of the restructuring proposals discussed at the symposium emphasized the use of a financial services holding company that 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 needed to prevent conflicts of interest and abuses of the federal safety net. While some participants thought 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 on 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. Others were concerned with the possibility of increased concentration of economic power if a revised regulatory structure allowed the development of large financial and commercial conglomerates.

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