

# Perspectives on Financial Restructuring

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As Henry **Kissinger** used to say in our White House staff meetings, when discussing economics, "It is with an unaccustomed sense of humility that I address you on this subject."

This distinguished group of scholars and practitioners, all pros on the subject of financial restructuring, requires me to approach the subject in the same way. While my background gave me a certain familiarity with the workings of the financial system, not the least of which was trying to meet my borrowing commitments, I must admit restructuring of the system was not a primary concern of my past. That changed dramatically as I began to work my new job at the Federal Deposit Insurance Corporation—the FDIC.

My colleague in the Ford administration, former Treasury Secretary William Simon, early on observed that most regulators and legislators approached the subject of banking law reforms as though they were trying to reenact the old fable about the blind man and the elephant. After due consideration, his perception changed. He decided that an elephant was by far too clean, noble, benign, and, above all, petite, to accurately, or humanely, compare with the body of banking regulations. When he made the comparison in later years, he felt he had to swap a brontosaurus for the elephant to get things in proper scale.

Of course, my comments are to be about perspective, and perspective, or the lack of it, is what the old fable is about. I would guess

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This paper was presented as the symposium's luncheon address.

that with all the expertise gathered in this room, most of you entered with a fairly fixed perspective on the future of financial institutions. We probably each have a firm hold of some part of the animal we call the financial structure and a firm conviction of what the whole thing really should look like. It is our modest hope that we of the FDIC can make a contribution to your thinking about the financial system and its future organization. For a considerable period, the FDIC has been at work on a project that, we think, you will find useful.

Although this project contains some conclusions, our aim has been *not* to come down from the mountain with a definitive set of tablets engraved with *the* restructuring proposal. Instead, our purpose has been to assemble historical, factual information that can be useful as a starting point on the road to our future **financial** marketplace. The FDIC's study, entitled "Mandate for Change: Restructuring the Banking Industry," copies of which are available for you, we hope will help us all to reason together. Your comments, civil or otherwise, are solicited.

For a long time, bankers, businessmen, regulators, and lawmakers have all, from their varied perspectives, been aware of problems developing in the structure of our financial system. But often, entrenched economic power, diverse views of history, and differences in regulatory philosophy have prevented the agreement essential for a comprehensive approach to creating a new structure. The recent banking bill passed by Congress is a case in point. To many of us, this legislation, while containing much of benefit, still contains many more temporary fixes, moratoria, and stopgaps, than is good for the system.

As we know, a journey of a thousand miles begins with a single step. But before that can be taken, it helps to know in what direction we wish to proceed. "If you don't know where you are going, any road will do." Everyone seems eager to start this journey, but this legislation reflects a certain lack of unity, to say the least, with respect to an agreed general sense of direction for the financial system. But as Henry Ford observed: "Don't find fault. Find a remedy." With this in mind, let me provide you with a little background on just how this latest FDIC study came about, along with an idea both of its scope, and of some of its findings.

When I was confirmed as chairman of the FDIC some 20 months

ago, I had one advantage. As a newcomer I did not have any fixed perspective on how a financial restructuring should be accomplished and, as I have said, I did not think about it much. Thus, it seemed useful to try to get together an organized and objective inventory of just what was on the table and find out what tools were available, drawing both from historical mandates and current options. Let me summarize then, our FDIC study.

The initial chapter gives the background that I have just covered. Chapter 2 deals with the changing marketplace and concludes that market developments have slowly but significantly altered banking's traditional role, effectively weakening it, diminishing its role in the economy, and reducing its capital ratios and its marginal safety.

The third chapter is an historical overview and perspective. It concludes that regulation of American banking institutions is involved in long and rather uneven cycles swinging back and forth like a pendulum, swinging from strict control to comparative freedom. As Professor Robert Higgs points out in his new book, "Crisis and the Leviathan," crisis tends to increase the growth of government control. When the crisis abates, the government loses some of its powers—but never all that it gained. This seems to apply to banking.

So at one extreme of the pendulum's arc; we see eras where the banking laws tend to leave the marketplace essentially much alone. Commerce and banking, for instance, are often intertwined. At the other extreme, we have periods of heavy government oversight and regulation, and to use the example again, relations between commerce and banking are carefully controlled. But overall the swings of the pendulum are not often evenly balanced, and the long-term trend, as Professor Higgs points out, is an increase in government control in the marketplace.

Thus, U.S. history mandates no set program. We've tried just about everything. When our laws are changed, they most often are changed in reaction to conditions that, starting as problems, have ripened into crises. This is why we seem to swing between extremes—from comparative freedom to strict control. Thus, our review of the past, not surprisingly, finds no inherent historical basis for stating that finance and commerce must be separate.

The study then proceeds to deal with the prohibitions set forth in the Glass-Steagall Act. It concludes that, in the 1930s, the general view of Congress was that the mixing of commercial and investment

banking threatened the safety and soundness of the banking system, created numerous conflict-of-interest situations, and led to economic instability. To alleviate these concerns, the Glass-Steagall Act was enacted. It appears that, to the extent that these concerns were valid, they could have been handled through less disruptive means. But abuses did occur. The study concludes that with a degree of supervision and regulation and some restrictions on bank affiliate powers, significant progress could have been made to correct the failures that occurred without the stringent measures of Glass-Steagall. Glass-Steagall was not the required answer.

Chapter 5 of the study examines the conflict-of-interest question in the banking system, and its potential for trouble. It states that after an analysis of several types of potential conflicts, that in every instance, it appears the level of abuse could be brought well within acceptable boundaries through supervision. In fact, the banking agencies have been successfully supervising the basic conflict of interest inherent in the banking system throughout their history since a great majority of bank directors borrow directly from their own banks.

Now we come to Chapter 6, which is the heart of the study and deals with "Safety and Soundness." This key section discusses the ability of bank supervisors to build an effective supervisory wall around the bank, no matter who owns it. The answer seems to be central to arguments about mixing banking and commerce. It defines the question, "Can we create a wall around banks that makes them safe and sound, even from their owners?" Some have argued that this violates human nature and common sense. Still, most regulations are designed to control poor human behavior.

If a "wall" can be built, direct regulatory or supervisory authority over nonbanking **affiliates** or even bank owners is not necessary. This is a question that has long puzzled and fascinated economic theorists and lawmakers, the generals and aides who rule the battlefield of banking law. But I thought it might be a good idea to consult some foot soldiers on the question—the FDIC's corps of bank **supervisors**—to get some practical opinions in addition to the theoretical ones already on hand in great supply. Because if such a wall can be built, it would seem to be the first step toward solving a great many questions regarding financial restructuring of banks.

The opinion of the FDIC's corps of professional bank supervisory personnel, speaking from experience gained in thousands of bank

examinations over a 54-year period, is that a "wall" is indeed "doable." Furthermore, this "wall" could be constructed in a simple, practical, and effective way. Also, it should be possible to determine what activities can occur either outside or inside the wall.

The keystone of this wall lies in appropriate bank safety **supervision**. I believe it is a fact of human behavior, at least in the United States, that a majority of people play by the rules. However, a small percentage usually do not. Thus, the supervisory challenge in creating a "safety and soundness" wall is to identify and restrain the minority who will abuse the system. If, to greatly simplify with an example, 90 percent of the bankers obey the law, and 10 percent seek to beat it, then the clear supervisory challenge is to see that as few as possible of **the** errant 10 percent succeed.

We asked our professional supervisory staff if they could create a wall, and if they could, what tools they would need. Their answer was that most of the materials needed are already at hand.

We at the FDIC are even close to having the manpower we would need to do our part of a creation of the wall. Currently, we have about 2,000 examiners and my staff tells me we could get our part of the job done with fewer than 2,500.

The requirements of the staff with regard to the inventory of regulatory powers are set forth in Chapter 8. They are as follows: First, retain the limitations on dealing with nonbank affiliates contained in Section 23A of the Federal Reserve Act. These would also need expansion to cover "nonbanking" subsidiaries of banks. Second, retain the new Section 23B just passed by Congress, which specifies that **all** transactions with affiliates be conducted at an "arm's length" distance. This section also prohibits any action which would suggest the bank is responsible for any action of the nonbank affiliate. Third, enhance authority to audit both sides of any transaction between a bank and its subsidiaries or affiliates. Fourth, authorize collection of certain financial data from bank affiliates, where needed. Fifth, clearly defined regulatory authority to require, from either a practical or risk standpoint, that any nonbanking activity be housed outside the bank, in either a subsidiary or affiliate. Moreover, the power is needed to exclude from the bank's supervisory capital computation any equity investments in such nonbanking businesses.

FDIC's bank supervisors, speaking from 54 years of examination experience, believe that these materials will be sufficient to construct

a workable "wall." The view of our supervisors is that out of the 10 percent of bankers who, *in theory, might* be prone to abuse the new rules, that these tools would be enough to catch at least nine out of ten of the abusers. It would also mean for the vast majority of bankers a better shot than they have now for improving their competitive positions, and as well as the capital, and safety, of their institutions.

If a "wall" is possible, where do we go next? I can tell you what my staff thinks. They would eliminate both the Glass-Steagall restrictions, as well as much of the Bank Holding Company Act. My staff takes the position that, given proper insulation of the bank, laws that require a holding company structure are redundant and, therefore, inefficient and unnecessary. Some say we should do this *immediately*. They make many persuasive points. But I personally do not think I would advocate racing down that road just yet. I have sat through too many meetings with Chairman Paul Volcker. I concur with Winston Churchill that "Honest criticism is hard to take; particularly from a relative, a friend, an acquaintance, or a stranger." I believe we need to be ready to discuss the proposals in detail before we act.

My reasons for this are simple. One lesson our historical review made clear was that our present financial marketplace is both more complex, and moving at higher velocity, than in any previous era. To me, this means charting a course that combines moving toward a relaxation of restraints on bank powers, ownership, and affiliates, while strengthening safety and soundness through supervision. The process of deregulating a part of an industry that has been heavily, and complexly, regulated for decades is not an easy one. No one can say *now* for sure where the course may have danger spots. But if the perspectives shown by FDIC research indicate that indeed, our course is passable, it is clearly a way to a better capitalized and more competitive banking system. As General Patton pointed out, "Take calculated risks. That is quite different from being rash."

We do not need to set an unchangeable course. We can move in a step-by-step process toward a less regulated structure, with an evaluation of each step along the way. The suggested step-by-step process is outlined in Chapter 9 of the FDIC study. However, if we can agree upon the fundamentals, we will know where our steps are leading us. We are headed toward a system that keeps banks safe because they are special but lets the marketplace around them operate

with freedom from bank regulators. This can create a safer and sounder system for depositors, users of the transfer system, borrowers and traders; a more competitive and better capitalized banking system, a simpler and less costly regulatory structure, and a system that can serve consumers more efficiently. It also assures that the Federal Reserve has its needed tools for monetary control.

As a member of the Washington bureaucracy, I am not unaware of the amount of agency and special interest turf that could be tom up by means of this restructuring—including the turf of the FDIC. Only an agreement of the private sector on these goals can move the mountainous bureaucratic and special interest line defending the status quo. As my old football coach used to tell me, to give us perspective, "The bigger they are, the harder they fall."

Sound financial restructuring will require the best **thinking** of the industry, the regulators, the academic world, and Congress. It is time we all get down to the business at hand, and we at the FDIC pledge to work with all of you to achieve a safe, sound, and competitive banking system.

### **Executive Summary\***

It has become increasingly apparent that our banking system is in need of major reform. The rapidly changing financial environment, in combination with the existing restrictions on banking activities, has resulted in the inability of banks to remain competitive players in our financial system. This has been characterized as a new form of banking crisis—not like the type that occurred during the early **1930s**, but one that will slowly erode the viability of banks and ultimately lead to a weak and noncompetitive system.

Today's financial markets reflect several fundamental forces that have permanently altered the financial landscape over the past two decades. Among these forces are the significant advances in technology, the growing trend toward the institutionalization of savings, and the unprecedented innovation of financial products and services. These forces have had an adverse impact on banks and bank holding

\*This is the **Executive Summary** of the Federal Deposit Insurance Corporation's study, entitled "Mandate for Change. Restructuring the Banking Industry," August 1987.

companies alike. In particular, they have eroded the traditional role of banks as the main providers of intermediation and transactions services.

There is almost universal agreement that something has to be done to allow banks and banking companies to become more competitive in a wider range of markets. However, there are widely divergent views as to what markets should be made available to banking, and what degree of supervision and regulation is necessary. The purpose of this study is to examine the issues that are relevant to determining the future role of banking and how governmental regulatory and supervisory activities should factor into the process. It should be stressed at the outset that the purpose of this study is not to redesign the bank regulatory system.

There are other important banking-related issues that are not addressed in this study. One of the most important questions currently facing the government is how to resolve the problems of the savings and loan industry. Whatever solution is devised, equity between banks and S&Ls must be achieved over the longer run with respect to supervisory and regulatory treatment. Another area that deserves careful thought is the appropriate role of deposit insurance; a brief discussion of some of the issues is presented in Appendix C.

Chapter 2 surveys the changes taking place in the financial-services marketplace, and their effects on the banking sector. It reviews changes in banks' relative market share in the financial sector, and examines the increasing importance of competition from various nondepository institutions and instruments. The discussion also addresses the effects these competitive developments have had on bank profitability and on the valuation of the equity shares of banking companies.

Historically, commercial banks' most important business has been commercial lending. However, banks have lost an important share of this traditional loan market, as the best customers of money-center and other large banks have turned to the cheaper **commercial-paper** market, Euromarkets and to foreign banks in the U.S. In just twenty years, between 1966 and 1986, banks' share of the commercial lending market declined from 88 percent to about 70 percent. The erosion of traditional lending markets is a source of particular concern because, in addition to the loss of profitable business, it may be driving bank lending into areas of substantially higher risk.



Chapter 2 also focuses on the declining profitability of the banking industry. By the end of 1986, aggregate return on assets of commercial banks had fallen to its lowest level since 1959, and return on equity was the lowest since 1968. The analysis indicates that despite the dramatic decline in profitability at small banks, in dollar terms it is **the** larger banks that account for most of the profitability decline for the industry overall. Moreover, the profitability decline is largely an asset-quality phenomenon.

In view of the declining market share and profitability of banking, it is not surprising that the securities markets appraise the future of banking pessimistically. The low valuation of bank holding company stocks relative to other industries means that banking companies may have difficulty raising the capital needed to compete effectively in the future. While it is not appropriate to ascribe all of the industry's problems to a changing financial environment combined with outdated restrictions on banking activities, some portion of the blame must be attributed to this source.

Chapter 3 examines, from an historical viewpoint, an issue that has become a fundamental part of the debate on banking reform: Should there be a "separation of banking and commerce"? American banking history has been used to support both sides of this debate. To a large extent, opposite conclusions have been reached based on divergent views of what is the appropriate banking entity. Some have looked to see if history supports the view that a "separation" has existed, using the bank itself as the relevant business entity. Viewed in this limited context, there is evidence that a separation of banking and commerce has existed in some form during much of our history. However, the issue of greater relevance is not whether commercial activities should be conducted within the bank itself, it is whether they should be permitted within a banking organization. In other words, should banks and commercial firms coexist under common ownership? Viewed in this light, the evidence indicates that there has never **been** a complete separation of banking and commerce in the history of American banking.

The law has always permitted individuals to own controlling interests in both a bank and a commercial firm. During most of our history, nonbanking firms also have been allowed to own some form of a bank. It is only since the passage of the Glass-Steagall Act in 1933 that affiliations between commercial banks and securities firms

have been restricted. Other affiliations between banks and **nonbanking** firms continued uninterrupted until 1956 when the **Bank** Holding Company Act became law. Even today, some commercial firms own banks.

Chapter 4 provides an overview of the reasons for passage of the Glass-Steagall Act. The chapter concludes that, to the extent the concerns expressed at that time were valid, the partial separation of commercial from investment banking mandated under the Act was not an appropriate solution.

It was demonstrated long ago, and in a convincing fashion, that the Great Depression in no way resulted from the common ownership of commercial and investment banking firms. The Glass-Steagall Act was largely the result of efforts by Senator Carter Glass, who was guided in his efforts by his belief in the discredited "real-bills" doctrine. Extensive Senate investigations into the practices of organizations that mixed commercial and investment banking functions revealed numerous abuses. However, many of these abuses were common to the investment banking industry; they had nothing to do with the intermingling of commercial and investment banking, and have been remedied in large part by the extensive securities legislation enacted in the 1930s. Abuses that were due to interactions between commercial banks and their securities affiliates were mostly conflict-of-interest situations which could have been controlled with less drastic remedies.

Until the **1930s**, the securities affiliates of banks were not regulated, examined, or in any way restricted in the activities in which they could participate. Not surprisingly, abuses occurred. A certain degree of supervision and regulation and some restrictions on affiliate powers would have contributed significantly toward eliminating the types of abuses that occurred during this period.

Chapter 5 reviews conflict-of-interest and related concerns raised by bank participation in nonbanking activities. These include: (1) transactions that benefit an affiliate at the expense of a bank; (2) transactions that benefit a bank at the expense of an **affiliate**; (3) illegal tie-ins; (4) violations of the bank's fiduciary responsibilities; (5) improper use of insider information; and (6) the potential for abuse due to a bank's dual role as marketer of services and impartial financial adviser.

Transactions that benefit an affiliate at the expense of a bank can

be controlled acceptably through restrictions such as those contained in Sections 23A and 23B of the Federal Reserve Act; oversight and supervision by the banking agencies; and, perhaps, supplemental measures to strengthen existing safeguards. Some number of banks will always fail due to fraud and insider abuse, but this need not threaten the stability of the system, which is the primary public-policy concern.

Transactions that benefit a bank at the expense of an affiliate are of less concern. This is due partly to disclosure requirements and federal securities laws which deter abusive arrangements between banks and securities affiliates. More importantly, however, there are few safety-and-soundness concerns surrounding most nonbanking firms. In fact, one benefit of allowing banks to affiliate with other **firms** is that **affiliates** can be sold to raise capital for the bank in times of financial difficulty. This provides a buffer for the FDIC, helps to maintain a stable financial system, and need not adversely impact the interests of the nonbanking firm's shareholders, creditors or customers.

Tie-ins that present public-policy concerns result primarily from information problems or inadequate competition. Information problems generally are best handled by policies that encourage or require greater disclosure of costs, alternatives, and other pertinent facts. When inadequate competition is involved in perpetuating tie-in arrangements, this represents an antitrust concern. Rather than prohibiting firms from offering multiple products as a policy response to this problem, measures to foster greater competition would be more appropriate. Tie-ins that harm consumers cannot persist if consumers have options and are aware that those options exist.

Similar steps could be taken to guard against the abuse of insider information. Since banks have created an effective "Chinese wall" between their commercial lending and trust departments, it would seem plausible that they could take **similar** steps if they are permitted to engage in activities that grant them access to other types of confidential information. Should the level of abuse prove unacceptable, however, additional safeguards and stiffer penalties could be implemented without prohibiting **efficiency-enhancing** combinations of activities.

The focus of Chapter 6 is to determine if there should be restrictions on the activities of banking organizations due to the need to

protect the safety and soundness of the banking system.

While it is acknowledged that maintaining the stability of the payments system is essential to maintaining stability in the financial system, it is shown that there are more efficient and more equitable ways to safeguard the large-dollar payments system than by maintaining restrictions on the activities of banking organizations. It also is suggested that the Federal Reserve would not be hindered in its efforts to conduct monetary policy if banking organizations were permitted to engage in a broader range of activities.

This is followed by a discussion of how to measure the **riskiness** of new activities and how to determine whether new activities **would** increase the overall level of risk-taking in the banking organization. While some possible new activities would pose few risks and could benefit the bank from a safety-and-soundness viewpoint, other activities might increase the overall level of risk if conducted within the bank. Thus, some activities may only be desirable if adequate safeguards exist to ensure that the bank is protected against excessive risks. However, since risk varies from activity to activity and from organization to organization, it is not possible to make sweeping generalizations; such as, for example, that “**commercial**” activities are **riskier** than financial activities.

Another safety-and-soundness concern is that, due to mispriced deposit insurance, banks have an incentive to take excessive risks. This incentive could be acted upon in markets newly opened to banks and would be extended directly to new activities if those activities could be funded with insured deposits. However, risk-taking in traditional bank activities is reduced due to governmental supervision and regulation. Risk-taking is also moderated by the fact that bank shareholders and management do face the prospect of total loss in the event of failure. Thus, incentives created by underpricing deposit insurance can be offset by controls on bank behavior and the threat of losses to shareholders and management. If new activities are conducted in entities outside of the reach of bank supervisors, then it is important there be safeguards to ensure that those activities are not funded with insured deposits.

Can banks be insulated effectively from the risks posed by new activities? The conclusion of Chapter 6 is that effective insulation is possible if new activities are placed in subsidiaries or affiliates of the bank. Subsidiaries and affiliates can be protected against legal

risks if certain procedures are followed to ensure that the operations are conducted in truly separate corporate entities. While there are economic incentives to treat different units as part of an integrated entity, these can be controlled largely through existing legislation such as Sections 23A and 23B of the Federal Reserve Act and proper supervision of the bank itself, with appropriate penalties for abuses. The marketplace will view different units within an organization as distinct corporate entities if they are, in fact, treated accordingly by the supervisory agencies. There is growing evidence that as bank supervisors make distinctions between banks and their holding companies and affiliates, the market will do the same.

In conclusion, new powers can be granted to **banks**, with appropriate safeguards to ensure that the banking system remains safe and sound. Some activities may be located within the bank if they pose no great risks. Others may be located in separate subsidiaries or affiliates, with safeguards structured to ensure that the bank remains viable regardless of the condition of the bank's affiliates and subsidiaries.

Chapter 7 discusses concerns related to equity, efficiency and concentrations of resources. One concern expressed by those who would limit bank involvement in nontraditional activities is that banks may possess unfair competitive advantages. These include certain tax benefits; access to the discount window, the federal funds market, and the payments system; and, most importantly, access to **federally-insured funds**. There is evidence that federal deposit insurance is underpriced in the sense that premiums do not accurately reflect the difference between rates actually paid on insured deposits and rates that would have to be paid in the absence of federal deposit insurance. This suggests that banks are subsidized, thus raising objections to new powers based on competitive inequities.

However, banks are subject to a wide variety of regulatory restrictions and controls from which **other businesses** are largely exempt. These include capital, reserve, and lending requirements; geographic and product constraints; and a host of other regulations. All of these impose costs on banks.

On balance, it is unclear whether banks possess a competitive advantage over nonbank firms. Regardless, equity can be obtained by allowing the same options to all. As banks are allowed to engage in nonbanking activities, nonbanks should be allowed into banking on the same terms as other banks. Given equal options available to

all, there need be no concern about competitive equity.

Another concern is the possibility that new banking powers will transmit the distortional effects of underpriced safety-net privileges (especially deposit insurance) to other markets, thus resulting in a greater misallocation of resources. It is uncertain how large the cost to society could be from this type of inefficiency. In any case, controls are in place, and can be strengthened, to prevent banks from 'exploiting any fund-raising advantages in markets newly opened to banks. Moreover, the sources of this potential inefficiency should progressively disappear as deposit-insurance pricing systems are developed and banks are subjected to greater market discipline through the refining of failure-resolution policies, bank-closure rules, regulatory accounting systems, and other aspects of bank regulation and supervision.

To the extent that expanded powers raise the potential for a greater concentration of banking resources, there are concerns that the outcome could include less competition, greater concentration of political power, and a more fragile banking system.

It is reasonable to assume that as geographic and product barriers in banking are lowered, there will be fewer, larger, and more diversified banking organizations. However, this does not mean there will be fewer banks or less competition in any given market. Technological advances have greatly reduced the cost of entry into new financial markets, and it is likely that they will continue to do so. This suggests that as excess profits develop in any market, they will be competed away, just as they are in today's highly competitive environment. As product and geographic deregulation further weaken entry barriers, this should increase both actual and potential competition in banking and ensure that even if the total number of banking organizations decreases, competition will remain strong.

While concentrations of political power may be undesirable, it is not clear that large organizations or highly concentrated industries are able to wield too much influence over government. In any case, the degree of concentration in banking is presently far below that of many other industries in which there is no apparent excess of political influence.

Finally, safety-and-soundness concerns need not be exacerbated by the development of a banking industry with fewer and larger entities than at present. A major reason why banks may grow larger

is to take advantage of diversification opportunities, which should strengthen banks. Moreover, as the number of banks decline, there will be fewer opportunities for banks to slip through the cracks and avoid governmental supervision that can detect unhealthy behavior. Although there is not sufficient evidence to conclude that undue concentrations will arise if banking and commerce are allowed to mix, these concerns **deserve** careful consideration by Congress.

Chapter 8 lays out a set of rules that most likely would adequately protect the stability of the banking system and the deposit insurance fund if restrictions on affiliates of insured banks and the regulatory and supervisory powers of the banking agencies on these organizations were removed. It is pointed out that transactions between banks and nonbank affiliates currently are subject to very tight restrictions, and that few changes to existing law would be necessary to protect the system even if a very conservative approach were taken.

It is suggested that all banks with access to the federal safety net should be subject to the same rules. Thus, uniform restrictions on dividends and lending limits should be extended to all insured banks. It is recommended that these same restrictions cover transactions and other dealings with direct **nonbanking** subsidiaries of insured banks, which are currently exempted from Section 23A- 23B-type activities.

While direct regulatory or supervisory authority over **nonbanking** affiliates is unnecessary, there are limited areas where the bank supervisory agencies need to retain or be given authority. These include the power to audit both sides of transactions between banks and nonbank affiliates, and ensure that advertising and other promotional material distributed by nonbank affiliates are consistent with the maintenance of "corporate separateness" between bank and nonbank affiliates.

This set of rules most likely would provide a very effective "wall" between an insured bank and any affiliated organizations. However, these rules are restrictive and may diminish the attractiveness of affiliations between **banks and nonbanking** firms. On the other hand, these rules ultimately could allow unanticipated abuses to occur that fall within the rules. The only valid test is to subject them to the "market," and make necessary adjustments in response to events as they unfold. The process of liberalizing the powers available to any industry that has been regulated for decades must be approached with a combination of caution and flexibility.

Two related issues also are discussed. First, the issue of how to treat investment in subsidiary organizations in measuring capital adequacy probably is best resolved by differentiating between the activities performed by the subsidiaries. It is suggested that investments in subsidiary firms that perform functions that could be performed in the bank not be deducted from capital and the subsidiary be subjected to supervision. Whereas, equity investments in other subsidiaries should not count in capital-adequacy calculations.

The second issue relates to the so-called "source-of-strength doctrine, *i. e.*, the ability of the regulatory agencies to force corporate owners to support subsidiary banks. From a practical standpoint, the best approach would be to use the normal applications process and supervisory activities to protect the deposit insurer from loss; this is the approach currently used in the case of banks owned by individuals.

The major conclusion of this study, as outlined in Chapter 9, is that insulation between banking entities and the risks associated with nonbank affiliates can be achieved with only minor changes to existing rules governing the operations of banks. Thus, systemic risks to the banking industry and potential losses to the deposit insurer will *not* be increased if activity restrictions and regulatory authority over bank affiliates are abolished.

The public-policy implication of this conclusion is that both the Bank Holding Company Act and the Glass-Steagall restrictions on **affiliations** between commercial and investment banking firms should be abolished. However, because of the importance of the banking industry to the economy and the high financial stakes that are involved, it is suggested that decontrol proceed in an orderly fashion to test these conclusions in the marketplace.

It is suggested that the provision of the Bank Holding Company Act pertaining to regulation and supervision of bank holding companies could be eliminated without undue risk to the system. Product liberalization then could be accomplished by an orderly legislative schedule first eliminating the restrictions imposed by Glass-Steagall then scheduling a gradual phaseout of certain provisions of the Bank Holding Company Act, with a specific sunset date when all limitations on affiliations would terminate.

This restructuring would be accompanied by a strengthening of the supervisory and regulatory restrictions on banks. "The prudent



supervision of banks would become more important, along with the need to monitor and limit risks posed by new activities conducted in the bank.

In summary, supervisory safety and soundness walls around banks can be built that will allow bank owners, subsidiaries, and affiliates freedom to operate in the marketplace without undue regulatory interference.