

Redesigning Regulation: The Future of Finance in the United States

Thomas F. Huertas

This symposium on restructuring the financial system is both timely and **important**.¹ There is a growing **realization** that the current **system** of financial regulation has broken down, and that a new system of financial regulation is needed.

What should that new system be? Recently, a number of proposals for restructuring financial regulation have been made, and the purpose of this paper is to evaluate those proposals. Which redesign of regulation will enable the United States to achieve the aims of financial regulation?

This formulation of the problem is deliberate. The issue is not deregulation or reregulation. Nor is the issue broader powers for banks. The issue is comprehensive restructuring of financial regulation.

Before examining proposals for restructuring, it is necessary to describe why restructuring is necessary. This is done in the first section of the paper. The second section then analyzes current proposals for restructuring, and a third section provides conclusions.

The old regulation and the new finance

Two factors make the redesign of financial regulation necessary. The first is a defect in the design of the old regulation that makes the system of regulation inherently unstable. The second factor is the emergence of a new finance, or changes in the economics of **finance**. These changes make the defective design of the old regulation

all the more apparent and all the more dangerous. **Correspondingly**, regulation must be redesigned. Some redesign has already occurred, but more is required, particularly with respect to the regulation of affiliation between banks and nonbank enterprises.

Cartel finance

The old system of regulation originated in the 1930s and was strengthened via the Bank Holding Company Act passed in 1956 and subsequent amendments. Its intent was to enhance the safety of financial instruments and thereby promote stability in the financial system. The means to these ends was a restriction of competition through a system of cartel finance. In other words, the cartel system of finance deliberately sacrificed efficiency in order to promote safety and stability.

This cartel system had two tiers. The first segmented the financial services industry into three distinct categories—deposit banking, investment banking, and insurance—and placed restrictions on affiliations between firms in one sector with a firm in another financial sector or with a nonfinancial firm. Deposit banking was further segmented into two forms—commercial banking and savings banking. The former was expected to finance business, the latter was expected to finance housing; and separate rules, regulations, and regulators were applied to each. This segmentation of the financial services industry was intended to prevent firms in one category from competing with firms in another. Each type of firm was to have its own "turf".

No single law segmented the financial services industry in the manner described above. Several have done so, and some of these laws remain in effect. Segmentation resulted from the Glass-Steagall Act (1933), segmenting commercial and investment banking, the Bank Holding Company Act (1956, amended 1970), restricting the affiliation of banks with nonbank enterprises, the Savings and Loan Holding Company Act (1969), restricting the **affiliation** of thrifts with **non-thrift** enterprises, and various state laws that restrict affiliations between banks and other enterprises or their agents, especially insurance agents. The early failure of the insurance law to provide for the formation or control of downstream subsidiaries foreclosed mutual

company diversification and contributed to the segmentation of the financial services industry, as did the rules of the New York Stock Exchange that banned corporations from owning member firms and prohibited member firms from engaging in or becoming affiliated with **kindred** businesses.¹

The second tier of the cartel restricted competition within each segment of the financial services industry. In deposit banking, competition was limited through restrictions on branching. Banks were allowed to branch only within their own state, and in some states, banks were not permitted to branch at all. Banks were also restricted by the Douglas Amendment to the Bank Holding Company Act of 1956 from affiliating themselves with banks in other states. Competition was also restricted via limits on the chartering of new banks. In combination, these restrictions on entry were intended to assure that every bank had a protected local market. Competition within banking markets was further restricted by ceiling on interest rates payable on deposits (Regulation Q). In investment **banking**, the New York Stock Exchange was allowed to enforce minimum brokerage commissions. In insurance, state commissions set minimum premiums on **property/casualty** insurance, and competition among insurance agents was prevented through antirebate laws.

In sum, cartel finance restricted competition in order to improve safety and stability. Like the NIRA codes for industry, which were declared unconstitutional by the Supreme Court, the regime of cartel finance rested on the assumption that restricting competition would improve profitability. And in finance (especially banking) it was reckoned that if firms remained profitable, the instruments (such as deposits) they issued would remain safe and the financial system would remain stable.

Things did not work out that way, for the cartel system could not work and did not work. Cartels are inherently unstable. The very system of regulation intended to produce stability led instead to instability.

¹ The insurance law applied only to downstream subsidiaries. There has never been any restriction on upstream affiliations or on the owners of insurance companies, and many nonfinancial companies have owned insurance companies (e.g., Sears has owned Allstate Insurance since the early 1930s). However, mutual insurance companies could not form upstream holding companies, so the insurance law effectively limited their diversification.

Cartels are unstable because they seek to substitute "administered" prices for those that would otherwise prevail in the market. For a time, this may produce high profits, but these high profits induce firms within the cartel to compete on terms that are not controlled by the cartel, such as quality of service or convenience. This may induce firms to incur higher costs and, therefore, reduce the profitability of firms within the cartel to normal levels. The high prices set by the cartel will also induce other firms outside the cartel to "skim the cream" off the most profitable segments of the cartel's market. Firms outside the cartel will enter into competition with the cartel, either directly or indirectly, by introducing products that are close substitutes for those produced by the cartel. If these substitutes prove attractive, the cartel's members will find themselves in a situation where costs are abundant but customers scarce. When this occurs, the cartel's rules will not coddle members but condemn them to extinction, as business flows elsewhere. Thus, the cartel may spark the very crisis that it is intended to prevent.

A perfect example of this is the recent history of the thrift industry. Prior to 1980, regulation prevented thrifts from paying a competitive rate of return on their deposits and channeled thrift assets into long-term, fixed-rate mortgages. Technology enabled nonbank firms to develop money market mutual funds with payment features—an instrument that looked like a deposit and acted like a deposit but paid a market rate of return. When market interest rates rose to levels 5 to 10 percent above the rates that thrifts were legally permitted to pay, depositors began to withdraw their funds—just at the time when the fixed-rate mortgages on the thrifts' books were plummeting in value. By preventing thrifts from competing for funds, the cartel system of regulation made hundreds of thrifts insolvent and illiquid, setting the stage for the current **bankruptcy** of the Federal Savings and Loan Insurance Corporation. Instead of stability, cartel regulation led to instability.

The new finance

The experience of the thrift industry reflected more general trends. Starting about 20 years ago, three fundamental forces began to undermine the system of cartel finance imposed by the old regulation. These

fundamental forces were advances in technology, the institutionalization of savings, and advances in financial theory. Together, these forces undermined the segmentation of the financial services industry that the old regulation attempted to impose, and together these forces are creating what might be called a new finance.

Technology is perhaps the most important of these fundamental forces. Since 1964, the real cost of recording, transmitting, and processing information has fallen by more than 95 percent. What cost a dollar in 1964 now costs a nickel (in 1964 dollars).

This decline in information costs fundamentally alters the economics of finance, for the existence of information costs is one of the primary reasons that financial intermediaries exist at all. These cost reductions make it easier and cheaper for investors to assess the risk and return of financial instruments. They make it easier and cheaper to subdivide financial instruments into small denominations, to trade those instruments, and to settle the trades. Lower information and communication costs also make it easier and cheaper to devise and execute complex trading strategies, conduct arbitrage operations, and segment and hedge against market risks. Finally, lower information and communications costs make it easier and cheaper to link geographically separate markets together. In sum, the reduction in information and communications costs makes it easier and cheaper for financial institutions to perform their functions as intermediaries, but it also makes it easier and cheaper for issuers and investors to bypass intermediaries and deal with each other directly.

A second fundamental force has been the institutionalization of savings. In the 1930s there were few pension funds and few mutual funds. Investors tended to be individuals, not institutions. Today that has changed. Institutions dominate the financial markets, and institutions manage extremely large amounts of savings for the benefit of households, corporations, and governments. All told, the top 300 institutional money managers now "run" about \$2 trillion in pooled investment funds—a sum equal to about three-quarters of the total assets of the nation's 14,000 commercial banks. These institutional money managers employ analysts, portfolio managers, and traders to make the fullest use of modern technology and modern financial techniques in managing the assets entrusted to them. Needless to say, these managers are not paid to deposit money in the bank. They are paid to invest, and they do so directly, at far lower spreads than

traditional intermediaries, such as banks or insurance companies, require in order to earn a profit.

The third fundamental force has been the development of financial theory, especially the theory of capital asset and options pricing. Combined with technology, these advances in financial theory have made it possible to develop a wide range of new financial instruments, such as options, swaps, and asset-backed securities. These new instruments **liquify** what were once illiquid assets, and make it possible to separate the credit-risk, interest-rate risk, and exchange-rate risk that were traditionally bundled into single financial instruments, such as bank loans or corporate bonds. Thus, these new instruments permit portfolio managers to manage and price risk more precisely.

Together, these three fundamental forces have changed the face of finance. Indeed, there is a new finance. Technology, the institutionalization of savings, and financial innovation have materially reduced the advantages of loans, deposits, and certain insurance products (such as whole-life insurance) relative to securities. Instead of borrowing from **banks**, **firms** issue securities. Loans on **banks'** balance sheets are securitized. Commercial loans have evolved into commercial paper, medium-term notes, and long-term bonds. Deposits have become mutual funds. Mortgages are being transformed into securities, and credit card receivables are now starting along that same route. In insurance, whole life gives way to variable and universal life, as policyholders bear the investment risk and reward associated with their policies. In sum, what can be securitized, will be **securitized**—and soon.

Along with the securitization of finance, there is a globalization of finance. Advances in technology and innovations in financial products make it possible for issuers to search the world for the cheapest source of funds and to swap the funds obtained into the currency and maturity actually desired. Similarly, advances in technology and improvements in portfolio management techniques make it feasible for investors to acquire global portfolios that provide greater diversification (lower risk) and greater returns than purely domestic portfolios. The result has been a vast increase in the volume of securities underwritten in the international markets and in investments made on foreign financial markets.

Finally, the new finance is characterized by an increasing integration of financial and nonfinancial services within a single diversified

enterprise. Again, the reduction in information and communications costs is key. Gathering information is costly; referring to information is cheap, and, more importantly, does not destroy the **information**. Consequently, information gathered for one purpose (e.g., to market cars and to assess the creditworthiness of customers applying for auto loans) can be used for another (e.g., to market home mortgages, insurance, or deposits). The result of lower information costs is increased economies of scope, and firms that make data do double duty find that they can produce and distribute products jointly more cheaply than independent firms can produce and distribute the products separately. As a result, firms that produce products jointly will tend to gain market share at the expense of more specialized firms. And that gain in market share will be faster and greater, if the integrated firm passes some portion of its cost savings on to consumers, or if the integrated firm actually combines the products in an innovative manner so as to increase convenience for the customer, as was done in the case of money market mutual funds.

In sum, securitization, globalization, and integration are the hallmarks of the new finance. These trends are fundamental and irreversible, for they are themselves based on fundamental and irreversible trends—advances in technology, the institutionalization of savings, and advances in financial **theory**.² Hence, the new finance is daily undermining the tenets of the old regulation—the segmentation of the financial services industry and the sedation of competition within each financial sector.

Regulatory redesign to date

Gradually, regulation is changing in response to these market forces. Over the past 10 to 15 years, the barriers to competition within segments of the financial services industry have fallen, and some of the barriers to affiliation of financial firms with each other or with nonfinancial firms have fallen as well.

² All of these developments occurred at a time of increased volatility in the real economy and (until the early 1980s) greatly increased inflation. These macroeconomic developments heightened the impact of the forces described here and made the transition to the new finance all the swifter. For example, greater volatility increased the demand for derivative financial instruments, such as swaps and options, that enable issuers and investors to hedge against risk

Within deposit banking, the cartel imposed by the old regulation is breaking down. Barriers to intrastate branching have practically disappeared, and barriers to interstate affiliations of banks are being relaxed. Entry into banking has also been liberalized; it is now easier to charter a new bank, and that has added to competition. Finally, and most important, Regulation Q, the ceiling on interest rates payable on time deposits, has been phased out.

In addition, differences between commercial banks and thrift institutions have also been reduced. Thrifts can now accept demand deposits from certain customers and make consumer and commercial loans. For all practical purposes, thrifts are now banks, although they continue to be subject to a separate system of regulation and supervision. In sum, competition within the deposit banking sector is increasing, although the old cartel still retains some of its force.

In investment banking, the cartel is also breaking down. In 1975 fixed brokerage commissions were eliminated. This has given rise to a whole new branch of the industry—the no-frills discount broker who executes customers' orders at rock-bottom prices but does not provide advice. Competition from these new entrants has forced "full service" brokers to cut their prices as well, at least to large volume traders, such as institutional investors. In the underwriting area, there is also more competition—both from the off-shore Eurodollar market and within the United States, where Rule 415 permits investment banks to bid directly for new issues.

In insurance, the cartel is also starting to break down. The minimum premium structures applied in property/casualty insurance have now been abolished in some states. The antirebate statutes are also under attack. For example, in 1986 Florida's Supreme Court declared that state's antirebate statute unconstitutional.

As these barriers to competition within financial sectors have fallen, so have the barriers to affiliation between different types of financial firms and between financial and nonfinancial firms. In 1969, the National Association of Insurance Commissioners developed a model law regulating insurance holding companies. In the following years, this model was adopted with substantial variations as law by virtually all of the states. These statutes permit insurance companies to form downstream subsidiaries engaged in any lawful business or to be affiliated with any business that is reasonably ancillary to insurance. In investment banking, the New York Stock

Exchange eliminated its rules prohibiting corporate membership in the exchange and prohibiting member **firms** from being affiliated with firms engaged in other businesses.

These changes have permitted insurance companies and investment banks to affiliate with one another, and such affiliations have become quite common. Leading investment banks have insurance affiliates, and leading insurance companies have investment bank **affiliates**. The change in stock exchange rules also facilitated affiliations between commercial **firms** and investment banks, and such affiliations are now quite common.

However, barriers to affiliation between deposit banks and other firms remain, and these barriers are the last vestige of the inherently unstable regime of cartel finance. The Bank Holding Company Act restricts the affiliation of banks with nonbank firms, and the Glass-Steagall Act prohibits member banks from affiliating themselves with entities that are principally engaged in the business of underwriting and distributing securities. The National Housing Act (Savings and Loan Holding Company Act) restricts the affiliations of firms owning two or more thrifts. And the laws of most states also restrict the affiliation of banks and thrifts with other enterprises, particularly insurers.

In many cases, these laws have "gates." Barriers to affiliation are not solid walls, but a maze of hedges through which innovative lawyers have found paths permitting certain types of affiliation between banks and nonbank firms. But the practical effect of the laws mentioned above is to restrict affiliation and limit the ability of firms to offer their customers a full range of banking and nonbanking **services** in the United States. Thus, a primary issue in restructuring financial regulation is how to redesign the regulation of **affiliation** between banks and nonbank firms.

Redesign proposals

That is precisely the issue addressed by a number of recent plans for redesigning financial regulation (Table 1).³ **All** of these plans focus on the question of affiliation. What may an enterprise containing a bank within its corporate structure do elsewhere within the corporate structure through nonbank affiliates or subsidiaries, and how should

TABLE 1
Summary of Selected Proposals for Regulatory Redesign

Item	Corrigan	OCC	ABHC	Heller	ARCB
Technique	Expand BHC	Bank subs	FSHC ¹	FSHC ²	FSHC ³
Permissible Affiliations for Banks					
Financial	Yes	Yes	Yes	Yes	Yes
Nonfinancial	No	Yes ⁴	No	Yes	Yes
Consolidated Official Supervision	Yes(Fed)	Yes(OCC)	No ⁵	No ⁶	No
Insulation Possible?	No	Yes	Yes	Yes	Yes
Supplemental Insulation Provisions					
Antifraud		X	X		
Stand alone		X	X		
Arm's length			X		
Limit on daylight overdrafts					X
Bear down					X
Back-stop				X	

OCC — Office of Comptroller of the Currency

ABHC — Association of Bank Holding Companies

ARCB — Association of **Reserve City** Banks

FSHC — Financial Service Holding Company

¹ As parent for the bank holding company

² As parent for the bank **holding** company. Commercial holding company could in turn own **financial services** holding company.

³ Could own a bank directly.

⁴ To the extent **compatible with** the safety and soundness of the bank.

⁵ The Federal Reserve would supervise intermediate bank holding companies have "oversight" over financial services holding **companies**, and enforce supplemental **insulation provisions** and **affiliation** restrictions.

⁶ The Federal Reserve would **supervise** intermediate bank holding **companies**.

such an enterprise be **regulated**?⁴

All plans build upon existing law and regulation. They envisage functional regulation of the bank itself and of whatever affiliates or subsidiaries a bank might be permitted to have. As at present, bank regulators would supervise the bank; securities regulators, the securities affiliates; state insurance commissioners, the insurance affiliates; and other regulators other affiliates, as **appropriate**.⁵ In particular, **all** plans leave the current structure of bank and thrift regulation intact, including the prohibition on interstate branching (**McFadden**) and the restraint on affiliation between banks in one state with banks in another state (**Douglas Amendment**). **Again**, the focus of the plans is affiliation between banks and other enterprises, not on the powers of banks themselves.

All plans focus on corporate affiliations. No restrictions are placed on individuals who control banks. Such "noncompany companies" may continue to control any other enterprise, including a commercial enterprise, in addition to the bank. **The** question addressed by the plans for regulatory redesign is whether corporations should be given similar freedom to control both a bank and any type of **non**-bank enterprise, and, if so, under what terms and conditions should the corporation be permitted to do so?

All plans envisage that banks should be permitted to affiliate themselves with a broader range of enterprises than those currently permitted under the Glass-Steagall and Bank Holding Company acts. Specifically, all plans envisage that banks should be permitted to have

³ Omitted from the plans covered in Table 1 is the proposal by Robert E. **Litan** for a regulatory redesign that would permit banks to have a **wider** range of nonbank **affiliates**, **provided** that **banks restrict their activities** to a range of safe assets. However, **Litan** does not **explicitly** discuss whether banks would be **permitted** to have **nonfinancial** as well as financial affiliates or whether there is a need for **consolidated** official **supervision** of the company **owning** such a narrow bank.

⁴ In this section, the word bank should be taken to refer to banks and thrifts. Most of the plans refer to banks only and **implicitly** assume that thrifts would be treated **like** banks. Paradoxically, however, the status of unitary **thrifts** is left unaffected by plans for regulatory redesign.

⁵ For example, **if** affiliations of banks and TV stations were **permitted**, the TV station would continue to **be** regulated by the Federal **Communications Commission**. Note that **this formulation** of **functional regulation** leaves open certain issues, such as the regulation of securities **activities** currently permissible for banks. Should these continue to be regulated by bank regulators, or **should such** activities be supervised by securities **regulators**? **If** by securities regulators, should the **activities continue** to be conducted within the bank **itself** or should they be conducted by an affiliate of the bank that is **registered** as a **broker/dealer**?

affiliates that engage in financial activities, such as securities underwriting and distribution, mutual funds, or insurance.

Finally, all plans are intended to be optional, in the sense that existing companies could continue to operate as they do today or take advantage of the broader opportunities for affiliation, as they so choose.

The plans differ from one another primarily in two respects—whether the entity owning the bank should be subject to consolidated official supervision (such as that imposed on bank holding companies today by the Federal Reserve Board), and whether banks should be permitted to affiliate themselves with nonfinancial as well as financial enterprises. Underlying these differences in the plans are different assumptions about whether banks can be insulated from their affiliates and whether permitting the affiliation of banks and nonfinancial enterprises would necessarily lead to an excessive concentration of economic resources.

Insulation

The insulation question is central to all of the plans for regulatory redesign. One school of thought holds that banks can be insulated from their affiliates, so that there is no need for consolidated official supervision of the entity owning the bank and no need to restrict the activities in which the affiliates of a bank may engage.⁶ The other school of thought holds that banks cannot be insulated from their affiliates, so that there is a need for consolidated official supervision of the entity owning the bank, and a need to restrict the activities in which the affiliates of a bank may engage.⁷

⁶ Note that the Association of Bank Holding Companies would restrict the activities of a bank's affiliates to financial activities, although it believes that banks can be insulated from their affiliates and that there is no need for consolidated official supervision of the parent holding company.

⁷ The Corrigan proposal exemplifies this school of thought. However, it should be noted that the Comgan logic does not necessarily lead to the precise plan proposed by Corrigan. Indeed, the assumption that banks cannot be insulated from their affiliates and that there is a need for consolidated official supervision is perfectly consistent with the concept proposed by the Comptroller of the Currency. In the OCC plan, all nonbank activities would be conducted in functionally regulated subsidiaries of the bank. The Comptroller would provide consolidated official supervision and would decide which activities were suitable for subsidiaries of the bank and the terms and conditions on which the subsidiaries could conduct such activities.

Insulation is a common problem in financial regulation. For example, insurance regulation insulates insurance companies from their affiliates so as to protect policyholders and limit risk to the state guaranty funds. Mutual fund regulation insulates mutual funds from their affiliates so as to protect the funds' shareholders and limit the risk to the Securities Investor Protection Corporation. Insulation is achieved by restricting the entity's transactions with its affiliates so that such transactions occur on terms and conditions that are at least as favorable to the insulated entity as those prevailing in transactions with unaffiliated third parties.

The same standard—that interaffiliate transactions be on **substantially the same terms and conditions** as transactions with unaffiliated third parties—is the appropriate standard to employ **when examining** the question of whether banks can be insulated from their affiliates. Such a standard safeguards the bank, but allows the bank to benefit from being part of a broader integrated enterprise.

However, this is not the standard employed by those who assert that banks cannot be insulated from their affiliates. For example, Gerald Corrigan defines insulation as a set of restrictions that would transform an operating subsidiary into a "truly passive investment," and claims that such insulation is impossible to achieve, since management will tend to operate an entity owning a bank as an integrated enterprise.⁸ Thus, Corrigan's assertion that insulation is impossible rests heavily on his particular definition of insulation, not on the commonly understood meaning of the term.

Similarly, for state-chartered, nonmember banks, the Federal Deposit Insurance Corporation could **determine the activities permissible for subsidiaries** of banks. In such case, the bank's **primary** federal regulator—the agency **chiefly responsible for ensuring** the safety and soundness of the bank—would **determine** the degree and manner of **diversification** for the bank and **provide consolidated** official **supervision** by a federal bank regulator

⁸ Note that **Corrigan's** definition of **insulation** would preclude transactions **with** affiliates even on terms that **plainly** favored the bank, and would rule out transactions, such as **cross-marketing** arrangements, that would produce **synergies**, **raise** the **consolidated enterprise's** overall rate of return on **capital** and so increase the **capability** of the overall enterprise to come to the **aid** of the bank, if the need arose. Note also that the standard of a 'truly passive investment' leaves open the **question** of what the owner of the bank should be **permitted** to do **with dividends** received from the bank. Many of the instances of **aid** to a nonbank **affiliate** cited the Federal Reserve as **evidence** of the **impossibility** of **insulation** were **in** amounts that were well **within** the permissible **dividend restrictions** on the bank. If by truly passive, **Corrigan** means that all profits should be reinvested **in** the bank **itself**, that needs to be **explicitly** stated

In fact, insulation—properly defined—is possible for banks and is consistent with allowing management to operate the bank and its affiliates as an integrated enterprise. In general, a bank can have three types of transactions with its affiliates: capital transactions, credit transactions, and all other types of transactions. To insulate the bank, such transactions have to be conducted on terms and conditions that are at least as favorable to the bank as the terms and conditions prevailing in **similar** transactions with unaffiliated third parties.

With respect to capital transactions, no restrictions need to be placed on infusions of capital, since they plainly favor the bank. Banks with affiliates are subject to the same dividend restrictions as banks without affiliates. Hence, banks with affiliates cannot upstream excessive amounts of dividends to their parents.

With respect to credit transactions, Section 23A of the Federal Reserve Act limits the amount of credit a bank can extend to any single nonbank affiliate and to all of its nonbank affiliates taken together to **10** percent and **20** percent, respectively, of the bank's capital and surplus, and it requires that any such extension of credit meet stringent collateral requirements. These restrictions make such extensions of credit considerably safer than extensions of credit to unaffiliated third parties. In addition, Section **23A** requires that all bank transactions with affiliates—including those covered by Section 23A and those specifically exempt from coverage—be on terms and conditions that are consistent with safe and sound banking practices. This has been interpreted to mean that any transaction between a bank and its affiliates must be on terms and conditions that are at least as favorable to the bank as those prevailing in similar transactions between the bank and unaffiliated third parties. Finally, securities law and regulation prohibit a bank's affiliates from stating or implying that their obligations are covered by federal deposit insurance. Thus, existing law and regulation already insulates banks from their affiliates according to the standard described above, and existing law and regulation has been quite effective in preventing failures of banks due to transactions with affiliates.

All of the plans for regulatory redesign keep in place existing insulation provisions. However, some plans provide for additional insulation of the bank, so as to raise the "R-factor" of the insulation provided to the bank. These supplemental provisions include an antifraud provision, a "stand-alone" requirement, an arm's length requirement,

a limit on daylight overdrafts by the **affiliates** of the bank on the bank, a "bear-down" requirement, and a "back-stop" provision.

The antifraud provision reinforces the antifraud provisions of the securities laws by prohibiting affiliates of banks from stating or implying that their liabilities are obligations of an insured bank or insured thrift and from stating or implying that their obligations are covered by federal deposit insurance. The stand-alone requirement also prohibits a bank from directly or indirectly guaranteeing the obligations of its affiliates and requires the affiliate to disclose this to investors.

The arm's length requirement makes explicit the interpretation of current law and regulation requiring that all **interaffiliate** transactions be on terms at least as favorable to the bank as those prevailing in similar transactions between the bank and unaffiliated third parties.

The limit on daylight overdrafts of an affiliate on the bank toughens the existing insulation provisions applicable to such extensions of credit. As it is, daylight overdrafts on the bank by bank affiliates are covered by the general rule contained in Section 23A that **inter-affiliate** transactions must occur on terms and conditions that are at least as favorable to the bank as similar transactions (daylight overdrafts) for unaffiliated third parties. However, daylight overdrafts are exempt from the quantitative limits and collateral requirements applicable to overnight (or longer) extensions of credit by the bank to its affiliates. The Association of Reserve City Banks (ARCB) proposal would subject daylight overdrafts by the bank's nonbank affiliates on the bank to the quantitative limits of Section 23A. This would limit the bank's exposure to any one nonbank affiliate to 10 percent of the bank's capital and surplus and its exposure to all of its **non-bank** affiliates taken together to 20 percent of its capital and surplus. Thus, daylight overdrafts of the nonbank affiliates on the bank could not cause the bank to fail, provided the bank was maintaining adequate capital at the time the affiliate defaulted on the overdraft.

To ensure that the bank does, in fact, maintain adequate capital, the ARCB plan also contains a bear-down provision. This requires the bank to maintain adequate capital at all times, and it empowers the bank's primary federal regulator to force the owner of the bank to divest the bank, if the bank's capital falls below the minimum required level. This is an extremely powerful provision, for it enables the regulator to step in well before the net worth of the bank is

exhausted. If enforced, the bear-down provision would fully protect the deposits of the bank and the deposit insurance funds from all risk, including any risk that might arise as a result of the bank's transactions with its affiliates.

Finally, the Heller plan contains a back-stop provision. This would require each parent in the corporate chain above the bank to assume unlimited liability for the subsidiary beneath it. This would make explicit the Federal Reserve's longstanding position that the holding company should be a source of strength for the bank. However, the effectiveness of this provision is open to question. In particular, the guarantee of unlimited liability is only as good as the company that gives it. Hence, it would be preferable for the financial services holding company to provide strength to the bank up front in the form of additional capital at the bank level. This would obviate the need for any capital requirements on the parent holding company and ensure that all banks controlled by financial services holding companies were financially strong.

Those various proposals to increase the R-factor in the insulation of a bank controlled by a financial services holding company can be combined in a way that yields a much greater increase in the R-factor than any one of the regulatory redesign plans submitted to date, and yet at the same time preserves the synergies that result from operating the bank as part of an integrated enterprise. This combination would preserve existing insulation provisions (dividend restrictions, Section 23A and the antifraud and disclosure provisions of the securities law) and add:

- The bear-down provision.
- The antifraud provision.
- An "extra-layer" provision. This would require that banks controlled by financial services holding companies maintain supplemental capital in addition to the minimum required capital to be maintained by banks that are not controlled by financial services holding companies. This would be in lieu of the back-stop provision.
- A plenipotentiary provision. This would grant the bank's primary federal regulator the authority to write rules and regulations regarding interaffiliate transactions so as to protect the safety and soundness of the bank. There would be severe civil and criminal sanctions for violations of such regulations. This

provision would enable the regulator to address in a flexible manner the concerns that prompted the explicit arm's length provision, the explicit prohibition on banks' guaranteeing the obligations of their affiliates, and the explicit limits on daylight overdrafts.⁹ It would also enable the primary bank regulator to address quickly other concerns that may arise as a result of changes in market conditions.

- An enforcement provision. This would grant the primary federal regulator of a bank controlled by a financial services holding company the authority to seek an immediate court injunction against any unsafe or unsound practice engaged in by such a bank. It would also grant the court the authority to order appropriate relief measures, including the divestiture of the bank, so as to bring such unsafe and unsound practices to an immediate halt. This would enable the regulator to proceed quickly against any bank controlled by a financial services holding company that engages in unsafe or unsound banking practices. In particular, it would enable the regulator to bypass cumbersome and time-consuming cease-and-desist procedures.

This comprehensive approach concentrates responsibility for insulating the bank in the hands of the federal regulator responsible for examining and supervising the bank (e.g., the Comptroller of the Currency for national banks). Rather than ossify all insulation provisions in a statute, this approach gives the bank's primary federal regulator the flexibility to adapt regulations to changing conditions and the power to stop any practice that he considers unsafe and unsound. Thus, this approach protects what needs to be protected (the bank), and assigns the job of protection where it belongs—to the bank's primary federal regulator. This is a much more direct and, I would argue, much more effective method of preserving the safety and soundness of the bank than consolidated official supervision of the entity owning the bank.

⁹ For example, the quantitative restrictions in Section 23A suggested by the Association of Reserve City Bankers are not the only way to control the risk to the bank presented by such overdraft facilities. Other means include the collateralization of overdrafts or a parent guarantee for the overdrafts of nonbank subsidiaries of the parent on the bank subsidiary. The primary bank regulator should have the flexibility to decide which of these solutions is appropriate or to develop others. Note that the risk to the Federal Reserve is a question of the overdraft of the bank on the Federal Reserve. This is distinct from the possibility that an affiliate may overdraft its account at the bank.

In sum, banks can be insulated from their affiliates, and current law and regulation meet the commonly accepted standard of insulation—the restriction of interaffiliate transactions so that they are conducted on terms and conditions at least as favorable to the bank as terms and conditions prevailing in similar transactions with unaffiliated third parties. However, it is possible to raise the R-factor of insulation applied to banks controlled by financial services holding companies while still preserving the synergies that result from operating the bank as part of an integrated enterprise. Thus, insulation provides no rationale for consolidated official supervision of the entity owning the bank and no rationale for restricting the activities in which the affiliates of the bank may engage.

The safety net and the payments system

The insulation question is also central to determining whether the reform of regulation of affiliation between banks and nonbank enterprises need to be linked to the question of reform of the federal safety net applicable to banks or to the reform of the payments system. If banks cannot be insulated from their affiliates, then reform of the safety net, of the payments system, and of affiliation between banks and nonbank enterprises are all interconnected with one another. If banks can be insulated from their affiliates, the reform of the safety net (deposit insurance and access to the discount window) and the payments system are problems separate and distinct from the regulation of affiliation, capable of separate and distinct solutions.

As mentioned above, Corrigan believes that banks cannot be insulated from their affiliates, and Corrigan, therefore, infers that the safety net applicable to banks also inevitably extends to the owners of banks as well. This leads Corrigan to the conclusion that the presence of a safety net for banks requires that owners of banks be subject to consolidated official supervision, and that each of the bank's affiliates be subject to some type of prudential supervision. Financial enterprises qualify on that score; commercial ones do not. Hence, Corrigan recommends that affiliations between banks and **nonfinancial** enterprises should be prohibited. Perhaps more significantly, **Corrigan** recommends that the safety net be extended to include finance as well as banking.

Once again, this conclusion depends heavily on Corrigan's particular definition of insulation and on his assessment that affiliates cannot be transformed into truly passive investments. It also depends on his "holy water" theory that the official approval of the acquisition of a bank and the ongoing examination and supervision of a bank imply the "de facto extension of parts of the safety net to any firm that would own and control banks."¹⁰

As discussed above, banks are insulated from their affiliates in the sense that they must transact with their affiliates on terms that are at least as favorable to the bank as those prevailing in similar transactions with **unaffiliated** third parties. Hence, the bank cannot transfer access to the safety net to its affiliates through transactions that favor the affiliates at the expense of the bank.

In fact, the safety net does not extend to owners of banks. When First National Bank & Trust Company of Oklahoma City failed in July 1986, the failure was resolved in a manner that protected the depositors and creditors of the bank but did not protect the owner of the bank, First Oklahoma Bancorp, or its creditors. Indeed, First Oklahoma Bancorp went bankrupt, and its creditors suffered severe losses. Creditors of the bank suffered no losses at all. In sum, the bank is protected by the safety net; the owner of the bank is not. Banks are insulated from their parent holding companies and **non-bank** affiliates.

Corrigan's "holy-water" theory does not change this. The official approval and monitoring process does not imply that the safety net extends to owners of banks. Under the Change in Bank Control Act, bank regulators examine the financial strength of the acquirer of the bank. However, following the acquisition of the bank, regulators monitor the bank itself, and intervene only if the bank does not meet regulatory requirements, such as the maintenance of minimum required capital. Nothing is implied about the extension of the safety net to the owner of the bank.

Should that situation change? Should owners of banks also be protected by a federal safety net? Should nonbank firms **also** be protected by a federal safety net? Corrigan thinks they should, as long as the

¹⁰ However, Comgan does not state exactly which parts of the safety net would extend to the owners of banks

firms are engaged solely in financial activities. Indeed, his "holy water" theory, coupled with his statement that the safety net applies to banking and finance, suggests that Corrigan believes the safety net already extends and should continue to extend to the owners of nonbank primary dealers, such as Salomon, Inc., and Nomura Securities, whose applications have been approved by and who are regulated by the Federal Reserve Bank of New York. In sum, Corrigan is recommending, albeit implicitly, a major expansion of the safety net to include the owners of banks as well as banks themselves.

This would be a serious mistake. The safety net should not be extended to owners of banks. Corporations that own banks are subject to the securities laws and to the general bankruptcy code. They must disclose to investors all material and relevant information, including the fact that their bank subsidiaries are subject to various restrictions, such as dividend limitations and minimum capital requirements; that restrict banks' ability to furnish resources to the parent. As a result of such restrictions, it is possible for the corporation owning the bank to go bankrupt, while the bank itself remains adequately capitalized and solvent.

This is well understood in the marketplace. Obligations of companies owning banks are generally rated lower than obligations of subsidiary banks. Moreover, the market distinguishes among the obligations of corporations owning banks, requiring higher rates of return on the obligations of some issuers relative to others. These differentials appear to be related to the risk of the issuer, so that owners of banks are subject to the same type of market discipline as other corporations. The extension of the safety net to the owners of banks would reduce and possibly eliminate this market discipline. It would remove the freedom to fail—precisely the freedom that Corrigan asserts should be part of any plan for regulatory redesign. To repeat, extending the safety net to the owners of banks would be a serious mistake.

Plans for regulatory redesign that assume banks can be insulated from their **affiliates** do not make that mistake. Such plans rightly conclude that the question of reform of the safety net and of the payments system are problems separable from the question of reforming regulation of affiliation. Moreover, some of these plans for regulatory redesign contain provisions that would improve the operation of the safety net or the payments system, at least as far as it pertains to banks

controlled by financial services holding companies.

Deposit insurance is a good example. Although the optimal R-factor plan described above does not specifically address the problem of deposit insurance, it improves the situation of the deposit insurance funds. Banks cannot pose excessive risk to the deposit insurance funds, if the regulators can reorganize or recapitalize the bank before its net worth goes to zero. The bear-down provision would allow regulators to do exactly that for banks controlled by financial services holding companies. Such banks would be free to fail, but failure would occur when the bank's capital dipped below the minimum required level. For example, if the minimum required capital for national banks were 6 percent of assets, a national bank owned by a financial services holding company would "fail" if its capital fell to 5.9 percent of assets. At that point, the Comptroller would be able to force the financial services holding company to bring the capital of the bank back up above the minimum level or to divest the bank. Thus, the bear-down provision ensures that banks owned by financial services holding companies will be recapitalized or reorganized before their net worth goes to zero, so that such banks cannot pose a threat to the deposit insurance funds.

Whether access to the discount window is in need of reform is open to grave doubt. In theory, only solvent banks may borrow at the discount window. All borrowing from the discount window must be on a fully collateralized basis, so that the Federal Reserve is not exposed to any risk when making a discount window loan. The discount rate may, at times, be below the rate for similar collateralized borrowings (such as repurchase agreements), so that banks could derive a benefit, if they could actually borrow from the window.

But banks do not have a right to borrow from the discount window. The Federal Reserve considers access to the discount window a privilege, not a right, and rations credit severely, so that solvent banks cannot borrow. Indeed, for a bank to approach the window for a loan that is large relative to the bank's own capital is usually tantamount to an admission of insolvency. Exceptions to this pattern (e.g., the loan to the Bank of New York to facilitate resolution of an operations problem) appear to be few and far between.

Perhaps it would be best to formalize this situation, at least for banks that are subsidiaries of financial services holding companies. Convert access to the discount window into a right rather than a

privilege. Any bank would have the right to borrow upon presentation of sound collateral. But all such borrowing would be at a penalty rate (say 2 percent above the rate for overnight repurchase agreements), and any such request for a discount window loan would trigger an immediate examination of the capital adequacy of the bank—an examination that could, in the case of banks owned by financial services holding companies, lead to the application of the bear-down provision and possibly to the divestiture of the bank. Administration of the discount window in this manner would ensure that the discount window would not provide an advantage to banks controlled by financial services holding companies.

The payments system does need reform, and concern has focused on the need to regulate access to **Fedwire**, the electronic payments system owned and operated by the Federal Reserve System. **Fedwire** allows a bank to make payments on behalf of its customers by transferring funds from its account at the Federal Reserve to the account of another bank at the Federal Reserve. The Federal Reserve guarantees all payments made over **Fedwire**, regardless of the size of the payment. When a bank sends a payment over **Fedwire**, the Federal Reserve debits the reserve account of the sending bank and credits the reserve account of the receiving bank. That credit is immediate and irrevocable. If the sending bank does not have sufficient funds in its reserve account to cover the payment, the Federal Reserve may extend the sending bank credit, i.e., it may allow the sending bank an overdraft. Such overdrafts are unsecured and interest-free, but are "daylight" only—they have to be repaid by the end of the day.

Thus, access to **Fedwire** carries with it a guarantee of payments received over the system and the potential to receive interest-free credit in connection with sending payments over the system. Together, these provisions ensure that the Federal Reserve assumes all risk in connection with payments made over **Fedwire**. The Federal Reserve attempts to control this risk by limiting the amount by which a bank can overdraw its reserve account. But these limits are based on banks' own evaluation of their creditworthiness. The lender, the Federal Reserve, does not routinely assess the creditworthiness of the banks to which it extends daylight overdraft credit. Thus, the Federal Reserve itself violates **Corrigan's** dictum that all the participants in the payments process should be making all of their credit judgments

in a rigorous and objective manner.

Corrigan proposes to remedy this by effectively eliminating or reducing the ability of some banks to run overdrafts on **Fedwire**. This would be done by requiring that major users of **Fedwire** maintain interest-earning liquidity balances (in addition to required reserves), some percentage of which would be a nonworking balance.¹¹ In addition, Corrigan proposes the formation of a National Electronic Payments Corporation, which would be jointly owned by the Federal Reserve and private participants, but which would be managed and operated by the Federal Reserve. Such a payments corporation would seek to eliminate operational risk in the payments system by establishing uniform technical standards for access, backup facilities, and other aspects of the payments system.

The rationale for these proposals is the assertion that the payments system represents some sort of natural monopoly or public utility. But *that* rationale is false. The payments system is not a natural monopoly. There are potentially as many electronic payments systems as there are banks, for customers of the same bank *can* make payments to one another by transferring balances *at* that *bank* to one another. Private interbank payments systems also exist. One example is CHIPS, the electronic payments system owned and operated by the New York Clearing House. Indeed, the volume of payments on CHIPS is approximately equal to the volume of payments made over **Fedwire**.

It is true that **Fedwire** is the dominant domestic electronic interbank payments system. But that does not imply that such a system is a natural monopoly. Instead, it implies that the Federal Reserve's **guarantee** of **payments** made over **Fedwire** gives **Fedwire** an unnatural advantage over alternative private systems.

Therefore, if a reform of **Fedwire** is required, consideration should be given to as wide a range of alternatives as possible, including the possibility of removing the Federal Reserve's guarantee of payments made over **Fedwire**, while retaining the requirement that payments made over **Fedwire** be final when made. In this case, receiving banks

¹¹ The liquidity reserve proposal would, according to Corrigan, do double duty. It would reduce daylight overdrafts, and it would provide the system with a "greater store of liquidity . . . , thereby providing a liquidity cushion short of the discount window." Corrigan provides no explicit rationale for this facility; if it is meant to expand access to the discount window to nonbank enterprises, that should be debated directly.

would be directly exposed to sending banks for the payments they agreed to accept over **Fedwire**, and receiving banks would exercise impartial credit judgments about sending banks. To the extent that credit was extended in the course of making payments, the credit would not involve the Federal Reserve. In such a case, **Fedwire** would operate much like the federal funds market, where transactions involve balances on the books of the Federal Reserve, but risks are borne by private parties. Indeed, removal of the Federal Reserve guarantee on payments made over **Fedwire** would in all likelihood lead to the development of an intraday federal funds market and to the pricing of payment transfers in line with the risks involved.

In sum, the presence of a safety net for banks is no reason for consolidated official supervision of the owner of the bank or to restrict the activities in which the bank's affiliates may engage. The safety net does not and should not extend to owners of banks. And plans for regulatory redesign that insulate **banks** do not aggravate whatever problems may exist in the safety net itself. If there are problems in the administration of the safety net, such problems affect all banks, and should be solved directly by changes in the safety net itself.

Concentration

A second reason for the differences in the plans for regulatory redesign revolves around concentration. Would permitting the **affiliation** of banks and commercial firms lead to an "undue concentration of economic resources" that could not be adequately controlled by the antitrust law?

The issue of concentration is separate and distinct from the issue of affiliation. Concentration implies that the firm has power in economic or possibly in political markets. Affiliation means that the bank has an affiliate. It says nothing about the market power of the bank, its affiliate, or the enterprise as a whole. Concentration can occur without affiliation, and affiliation does not imply concentration.

In economic markets, concentration means the power of a **firm** to raise the price of a product or service above its competitive level. This power depends on barriers to entry by other firms into that market. If anyone can legally enter an industry, no firm in the industry can exercise market power, unless there are natural barriers to

entry. And in finance, there do not appear to be any significant natural barriers to entry. Hence, removing the artificial barriers to affiliation between banks and nonbank firms is a sure way to reduce whatever economic power may currently exist in banking and finance.¹²

In political markets, concentration means the power to influence legislation and regulation. Any law that restricts entry into an industry confers wealth on the entities that are protected from competition, and this tends to create a constituency in favor of the law. The current system of regulation is no exception. Barriers to affiliation between banks and nonbank firms protect specialized financial firms from competition and raise the profits that such firms can achieve. Consequently, specialized firms have the incentive to reinvest some of the excess profits generated by regulation to lobby for a continuation of the very system of regulation that generates those excess profits. In this sense, excessive political power is far more likely to result from retaining barriers to affiliation than from removing them.

In sum, barriers to entry produce concentration. Eliminating the **barriers** to affiliation between banks and nonbank firms would, therefore, reduce concentration. Current plans for regulatory redesign take steps in that direction, but plans that call for consolidated official supervision and prohibit affiliations between banks and **commercial** firms do not go far enough in reducing **concentration**.¹³ To reduce concentration, one should eliminate barriers to affiliation contained in the Glass-Steagall Act, the Bank Holding Company Act, and state antiaffiliation laws.

¹² If there are no barriers to entry, traditional concentration or market share ratios are meaningless as indicators of market power. Conversely, if there are no **significant barriers** to entry, such as the **barriers** to entry posed by the Glass-Steagall Act or the Bank Holding Company Act, even small **concentration** ratios are consistent with firms' exercising market power, and large **concentration ratios**, such as those present in local deposit markets or in underwriting corporate securities in the United States, are almost certain indicators of market power.

¹³ Specifically, Corrigan's plan states that today's bank holding companies "could *in time*" (1987a, p. 34, emphasis in original) engage in a broad range of **financial** services under such terms and conditions as the Federal Reserve deemed appropriate. Corrigan does not advocate repeal of Section 20 of the Glass-Steagall Act and evidently does not contemplate **putting** investment banking and insurance onto the laundry list of **permissible** activities for bank holding companies. **Expansion** into new **activities** would evidently be on a case-by-case **basis**. Thus, barriers to entry into nonbank **financial** services would be preserved, at least temporarily. In contrast, the Corrigan plan appears to accord nonbank financial firms **immediate** entry into **banking**. Corrigan (1987a, p. 35) states that a financial **holding** company could "*at its option acquire* depositories" (emphasis added).

What should remain are the barriers to affiliation contained in the Change in Bank Control Act and in the antitrust law. The former is used to prevent unfit and improper persons, such as drug dealers, from acquiring control of a bank. This initial screening is appropriate and should be used to prevent firms controlled by criminal elements from gaining control of a bank. The antitrust law should be fully applicable to banks and firms that control banks. This is the proper way to control concentration, not through prohibiting affiliations of banks and nonbank enterprises.

There would be one standard for antitrust, not one for banks and one for nonbanks. Much of the original rationale for the **Bank** Holding Company Act of 1956 was the perception that the antitrust law did not apply to banks. That perception is now wrong. The Supreme Court has ruled that the antitrust law does apply to banks. Hence, there is no need for a special antitrust standard applicable to banks or the owners of banks.

So much for the economic logic of the case regarding concentration and affiliation. There remains the perception that permitting affiliations between banks and nonfinancial firms would induce large commercial firms to take over large **banks**—**and** such giant firms must be bad. To cite the extreme example used by Corrigan, permitting affiliation between commercial firms and banks might mean that General Motors could and possibly would take over Citibank—and that has to be bad.

Even if that were bad, it does not follow that prohibiting all affiliations between banks and commercial firms is the proper remedy. If takeovers are the problem, control takeovers; do not prohibit affiliations of all sorts. And, if takeovers are the problem, or if the size of firms is the problem, it is likely to be a problem for firms in general (e.g., suppose IBM took over Exxon). Therefore, the proper remedy is revisions in the securities laws or the antitrust law. There is no need to accord the managers of large banks special protection from takeovers.

In sum, the issue of concentration is something of a red herring. If anything, permitting the affiliation of banks and nonbank enterprises would reduce concentration, not increase it. The real issue seems to be size per se and takeovers. But these are issues that affect firms in general, and they should be resolved by changes in the antitrust law and/or the securities laws. There is no need for a special

standard for banks.

Conclusion

The conclusions to be drawn from this survey can be briefly stated. The old system of regulation is broken; regulatory redesign is needed. Various plans have been proposed, all of which focus on the key issues of affiliation of banks and nonbank enterprises and the regulation of an entity that owns a bank.

The plans differ in two respects. One set of plans asserts that there should be consolidated official supervision of the entity owning the bank and that affiliations between banks and commercial **firms** should be prohibited. The other set of plans asserts the opposite: that there is no need for consolidated official supervision of the entity owning the bank, and that banks should be able to affiliate with any other type of firm, including a commercial firm.

This paper has argued that the latter set of plans is the better way to redesign **financial** regulation. These plans insulate banks from their affiliates, do not strain the safety net, and offer the prospect of greater reductions in the concentration of economic and political power. Therefore, regulatory redesign should be based on two principles: protecting the bank through insulation rather than consolidated official supervision of the entity owning the bank, and permitting the **affiliation** of banks with financial and nonfinancial firms. More simply put, the twin tenets of the new regulation should be functional regulation and free affiliation.

References

- Association of Bank **Holding Companies**. "Financial Services **Holding** Company Act of **1988**," draft IV, May 15, **1987**
- Association of Bank **Holding Companies**, Emerging Issues **Committee**. "Proposal for a Financial **Services Holding** Company," May **1987**.
- Comptroller of the Currency, Office of. Order **allowing Continental Illinois** Bank and Trust to **acquire First Options of Chicago**, Inc., dated December **26, 1986**.
- Corrigan, E. Gerald., *Financial Market Structure. A Longer View*, Federal Reserve Bank of New York, 1987a.
- _____, "Statement before the United States Senate Committee of **Banking**, Housing and Urban **Affairs**," June **18, 1987**
- Heller, H. Robert, "A Double Umbrella for the Banking System," **1987**.
- _____, "The Shape of **Banking** in the **1990's**," address before the Forecasters Club of New York, June **26, 1987**
- Litan, Robert E "A Comprehensive Approach to **Financial Produce Diversification**," in *What Should Banks Do?* Brookings Institution, **mimeo**, June **12, 1987**, pp. **278-326**.