

Commentary on "Proposals for Financial Restructuring"

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I would like to congratulate Roger Guffey and his colleagues at the Federal Reserve Bank of Kansas City for their foresight in determining the topic of this year's conference. "Restructuring the Financial System" is certainly an important issue of discussion and debate in Washington, financial institution circles, and elsewhere in financial markets in this country.

The papers that were discussed yesterday and the papers that were presented today are evidence that a lot of very intelligent people have spent a good deal of time looking at both the need and the rationale for the restructuring of our financial system. This morning, I would like to take the liberty to comment on both the titles assigned to Thomas Huertas and James **Tobin** and the papers they have written.

The case is often made that the marketplace is ahead of Congress, the courts, and the regulators in shaping our financial system. Part of the reason for that is, of course, that the regulators have their hands tied by existing law, and Congress finds itself in virtual gridlock because of competing self-interest lobbies. More basically, Congress has never been eager to decide on how the financial services pie should be sliced up for different industry groups.

Another reason why we have had congressional inaction over the past five years may be that the issues have been approached in a manner that is self-defeating. The electorate just does **not** get excited about what type of new powers banks ought to have or how profitable banks are or should be. A more fruitful approach may be to debate how our financial system should be shaped in the future to preserve and

protect the safety, soundness, and stability of our financial markets and to improve financial services for all customers.

Several people at this conference have already reviewed the forces that have been driving change in the U.S. and world financial systems. I will not dwell on them. However, I would note that while technology, communications, and customer demand are forces that are very hard to reverse, we have not had a full economic cycle on which we can judge the permanency of some of the financial changes and innovations we see around us.

Goals of financial reform

Before commenting directly on the two papers that are the focus of this session, I would like to digress slightly. In my view, the first objective of any discussion of financial reform, restructuring, or new approach to regulation either here or in Congress ought to focus the debate on what the *goals of financial* regulation are now and what they ought to be in the future. Only after a given set of goals is agreed to can a rational system be designed to meet those goals. This type of debate and agreement has, as I observe the landscape, been lacking. As things stand now, not even the goals of financial regulation in today's environment have been agreed to by all parties, let alone how we should deregulate the financial system—witness calls for financial institution holding companies, modification of bank holding companies, and even calls for a "brave new world" of virtually no regulation.

In looking at several of the proposals for comprehensive financial reform, you can see bits and pieces of various sets of goals for regulation but only limited uniformity of what the goals of financial regulation ought to be in today's environment. To his credit, **Tobin** outlines a coherent set of goals in his paper. **Huertas** is not explicit in this paper, but one has the feeling that implicitly he has a set of goals in mind. Yesterday morning Franklin Edwards proposed a set of goals in his discussion of change in the financial system, and Gerald **Corrigan** has a set of goals in his "Blue Paper." Still another set is contained in Henry **Kaufman's** recent testimony before the Senate Banking Committee. In all of these, there are similarities and differences, but no consensus.

As a starting point, and for no other reason, I would like to put on the table for discussion the set of goals that are enunciated quite clearly in a 1986 report of the House Subcommittee on Telecommunications, Consumer Protection, and Finance, the committee with jurisdiction over securities powers in the House of Representatives. Those goals for financial regulation seem to me to encompass most of the things that have been mentioned here during our discussion and in the papers I have mentioned. As grist for the mill, they are as follows:

- (1) To ensure access to capital and credit, to all types of participants in financial markets.
- (2) To balance competition with safety and soundness, recognizing the quasi-public character of financial institutions.
- (3) To enhance the efficiency of the market system by preventing conflicts of interest and concentration of financial resources, ensuring impartiality in credit decisions, and a large number of participants.
- (4) To ensure that the financial system exercises its fiduciary responsibility, particularly by channeling funds into productive uses and by being a catalyst for economic growth.
- (5) To protect customers by ensuring integrity of institutions and markets and by cushioning the impact of failures.

These goals may not be the perfect set, but they or a similar set should be debated by Congress and adopted as a reference point in **making** major financial restructuring decisions. Moreover, such a set of goals for financial regulation must be distinguished from any particular regulatory blueprint. In that way, turf fights can be avoided or postponed. The same set of goals should also be used in **looking** for any necessary modifications of the current regulatory framework.

The federal safety net

Another set of issues that needs to be determined by Congress before decisions can be made about the appropriate structure of the financial system is the efficacy of the federal safety net. **Tobin** has clearly indicated how federal deposit insurance—that is, government support

of depositors—has been distorted from its originally intended purpose and how it in turn is causing distortion in the financial system. Before satisfactory answers to the questions of restructuring can be given, Congress must, in my view, decide anew the extent to which the safety net applies, and how far the safety net should be stretched. To do otherwise would compound current problems that are already quite serious.

The federal safety net is thought of most commonly as being composed of three parts: federal deposit insurance, access to the discount window or the lender of last resort, and the system of **supervision** and regulation. Huertas adds to this list access to the payments mechanism. But, in my view, access to the payments mechanism is not a part of the safety net. Rather it is a privilege of regulatory design. The **subsidies** that it currently conveys could be minimized by appropriate pricing of the services provided, recognizing that the payment system itself has characteristics of a natural monopoly.

Deposit insurance actually plays two roles as part of the federal safety net: first, it protects depositors, and second, it provides for added stability in the financial system. The fact that these two roles sometimes gets intertwined is part of the problem. Originally, as several people have pointed out, deposit insurance was aimed at protecting small depositors, those who had no other alternatives. Today's deposit insurance system, however, has been twisted somewhat by events and now extends deposit insurance to \$100,000 per deposit, per institution, allowing almost unlimited deposit insurance per depositor, depending on how much time a depositor wants to spend in dividing up personal wealth among several institutions. This distortion is in serious need of correction, and with all the available new computer technology, we should be able to have a system limiting insurance on a per-depositor basis. We should also consider whether the regulating system would be cleaner and safer if the Federal Deposit Insurance Corporation (FDIC) was a pure insurance agency and not both an insurer and regulator.

I would note that when deposit insurance was originally instituted, another aspect of the safety net was put in place—regulation of interest rate ceilings. The combination of deposit insurance and interest rate ceilings was meant to be the protection both for depositors and for institutions holding the deposits. However, when interest rate ceilings were removed by Congress in 1980, no changes were made to

deposit insurance.

Today's situation, as **Tobin** and others have pointed out, is one in which deposit insurance has been taken advantage of, and it now may be detrimental to stability in the financial system. Deposit insurance today gives little or no incentive for depositor, debtor, or market discipline to be exerted. And certainly, as we deregulate, discipline from these quarters will be more rather than less important.

For example, certain thrifts in Texas are bidding up deposit rates by some 300 basis points over Treasury bill rates in an effort to attract funds and those funds are being used for somewhat speculative investments. At a minimum, those types of institutions should be restrained in their ability to offer rates far above any reasonable market rate, and **Tobin** gave a very good example on how that might be done. Let me stress again, this is an issue that Congress, in my view, must confront before decisions can be made on a rational basis for restructuring the financial system.

The second troublesome issue with deposit insurance is its role in fostering financial stability. In the extreme, deposit insurance backed by the full faith and credit of the U.S. government could be viewed as insuring all the liabilities of all of the depository institutions in this economy, not only those that have been termed "too large to fail." That provides for financial stability, but at the same time it leads to undue risk-taking. And the situation would deteriorate even more if, by chance, Congress decides that the line between banking and commerce could be erased. Certainly, a mixing of commerce and banking with today's deposit insurance structure could extend government protection against failure to every potential owner of an uninsured financial institution. This would certainly violate the set of goals mentioned previously.

The role of the Federal Reserve as lender of last resort also needs some adjustment. Here again we have a public policy tool that plays several roles that sometimes get intertwined. The discount window, as originally designed, was meant to be a liquidity facility for banks with temporary cash needs. It was not intended as a source of funding for depository institutions experiencing serious financial difficulties. The discount window is also used by the Federal Reserve Board in its implementation of monetary policy from time to time when changes in the discount rates are meant to signal to the market a change in the direction of policy. How important those signals are

is difficult to evaluate. Indeed, I have some sympathy for this policy tool, but certainly it is not a safety net function. One of the proposals that has long been on the table is to make the discount rate a floating penalty rate above the federal funds rate by 100 to 200 basis points. That proposal should be reconsidered.

At any rate, the Federal Reserve in its role of central bank has responsibility for financial stability, and its discount window certainly can and should be brought to bear in situations where financial stability is threatened by a failure of a depository or perhaps even a nondepository institution. The interaction of deposit insurance and the lender of last resort needs to be looked at as supplementary tools.

The third aspect of the federal safety net, supervision and regulation, becomes more important as statutory barriers to mixing various types of financial activities are removed. As a general rule, when there is less statutory or agency regulation there will need to be greater and more forceful **supervision**. However, there are practical limits as to how much we can expect from either supervision or regulation. Supervision of 15,000 to 20,000 banks and thrifts is not an easy task.

Unless the regulations themselves are spelled out in the law with extraordinary clarity so that there is congressional guidance given to the institutions and the regulators, supervision and agency regulation will have to shoulder a very heavy burden.

There is also a difference between regulation and supervision. In this country we have relied to a great extent on a complex system of regulation, set forth in a process combining congressional will and regulatory responsibility. Supervision to ensure that those regulations are being followed has not been as forceful as it might have been. There are numerous reasons for that, but certainly part of the reason is that the supervisory staffs do not have a more accurate crystal ball than the bankers. It is entirely reasonable that both the supervisor and the supervisee would miss changes in the economic conditions and other exogenous factors as they develop.

In many other countries, the balance between **supervision** and regulation is structured differently, partially because their financial systems are structured differently and the number of institutions are far smaller. For example, in Great Britain, there is less formal regulation set down by law or regulatory guidance. The Bank of England's relationship with its banks is predicated on customs and characterized

by an intensive, hands-on, day-to-day system of supervision. That works for Great Britain because there are far fewer institutions there than **here**. At any rate, both the nature of federal regulation and the degree of supervision have to be modified under most of the restructuring scenarios that have been put forward.

One of the benefits, as well as, one of the difficulties, that we have in our system is the great number of smaller institutions. Such institutions require less supervisory presence than the multinationals, but today both must abide by the same regulations. One possible approach is to differentiate the regulatory and supervisory requirements that are applied to banks that are either small in relative **size** or noncomplex in that they have few, if any, nonbanking activities. The smaller banks would not necessarily have to comply with the full set of rules and regulations that would be implemented to separate the bank functions from complex activities of financial services holding companies or bank holding companies, whichever term is used. On the other hand, the more complex the holding company, the more scrutiny in terms of supervision and the more regulation in terms of rules would need to apply. This reference is, of course, to the types of insulating factors that **Huertas** discusses in detail in his paper, a subject to which I would like to return in a couple of moments.

Why the push for restructuring?

In examining how various aspects of our safety net ought to be rearranged and how we would implement various policies to ensure that the goals of financial regulation are met, I have found it useful to ask the following questions: Why do various nonbanking entities want to get into banking? And the reverse: Why do banks want to get into **nonbanking**? Can the grass be greener on both sides of the fence? Perhaps, although I doubt that more competition can increase the size of the pie. Nonetheless, I think the answer to these two questions are instructive in framing ways to meet the goals of financial regulation because such an analysis may illuminate areas of advantage and potential abuse. They also provide some insight into the subsidies nonbanks seek when purchasing or establishing nonbank banks or nonthrift thrifts, and in the current debates.

I must confess that I have not conducted a scientific survey to get

the answers to these questions. But in reviewing what has been said over the past several years in congressional debate and elsewhere, I have come up with five reasons why nonbanks might want to own and operate banks:

- (1) ***To obtain access to an insured deposit base.*** Such a base would provide a cheaper source of funding for certain types of activities, allow for new-product diversification, and provide existing customers with an alternative third-party payment product.
- (2) ***To obtain access to the federal safety net.*** I refer to that part of deposit insurance and access to the discount window that provide for financial stability, both for institutions and the economy as a whole. In particular, banks and bank holding companies are able to operate at lower capital levels than some other types of financial firms that do not have the support of the safety net. Put another way, **thrifts**, banks, and bank holding companies are able to leverage themselves at a higher rate than noninsured financial institutions. Also, affiliates of bank holding companies may find it possible to fund themselves at a lower market cost than nonaffiliated providers of similar financial services.
- (3) ***To obtain access to the payments system.*** There are several ways that this may be advantageous to nonbanks. First, by avoiding the use of banks they could save on banking fees. Second, by having a bank that may participate in **Fedwire**, an institution could take advantage of the ability to have daylight overdrafts with the Federal Reserve. Third, and in the extreme, the ownership of a "captive" bank allows a nonbank to avoid the same type of credit scrutiny that it would have to face if it used an independent bank. Finally, access to the payments mechanism provides a nonbank financial institution with the ability to provide additional types of services to its clientele.
- (4) ***The ability to synergistically market product and services of the nonbank affiliates, be they financial or commercial, through various products offered by the bank, and vice versa.*** So-called "tandem operations" may be more important for commercial **firms** than for purely financial firms.

- (5) *To avoid certain laws or regulations that may apply to some institutions but not others.* For example, some owners of nonbank banks have indicated that one benefit of ownership is the ability to issue a nationwide credit card without having to abide by certain state usury laws.

This list probably could be expanded. But even as it stands, it certainly provides some insight as to which areas of bank regulation and supervision may need to be examined more carefully as the debate on restructuring moves forward.

The other side of the coin is the question as to why banks want to get into nonbanking businesses. This, I think, can easily be divided into two parts: entry into other financial and nonfinancial activities. The most frequently stressed rationale for banks gaining new financial powers, defined in various ways, is to increase their profitability. Unfortunately, while bank profitability may be secularly declining, this type of argumentation does not go very far in a political environment, not far at all. In fact, the counterargument to this has had successful political appeal—if banks cannot make profits at banking, how can they be successful at other activities? The second most cited reason for new bank powers has been the need for large size: banks need to be sufficiently large to compete internationally. Again this type of argument raises more political concerns about economic or political concentration than it makes points in the debate. Bankers also cite the need to “follow their customers either across state lines or to offer products that are substitutes for traditional banking products.” Politically, the nature of the debate needs to be changed. Back to the goals of financial regulation!

The need for banks to expand into nonfinancial areas is not often stressed by bankers. I tend to think that much of the argument for banks getting into commerce and for commercial firms owning banks is one that has been posed not because of the perceived benefits to banking institutions. Instead, commercial firms have been enlisted by some banks as allies in the debate for broad financial reform. Conceivably, such a strategy could be viewed as one that maximizes the likelihood of achieving an expanded set of financial products, even if there were little or no gains on the commercial side.

The Congress

One of the major questions that I would put in the category of "crystal-balling" is how Congress will approach the whole financial restructuring debate. As I have indicated, Congress has a difficult time picking winners and losers, dividing up the financial pie, or answering to more than one of the many competing interest groups. Financial restructuring issues are **difficult** to move ahead, except, of course, in times of crisis when often immediacy and practicality win out over long-term good. That is why I believe financial restructuring right now as a long-term goal is intellectually interesting and a useful debate, but as a short-term goal it is somewhat wishful thinking.

Congress, like economics, primarily focuses on a series of marginal changes unless there is some particular reason to make wholesale changes. That is not to say wholesale changes are impossible, but they take a certain amount of political will, public support, and commonality of need to be accomplished. Witness, for example, changes in the tax structure or social security. At least in the **tax** debate, there was a wealth of public support for lower tax rates. In the case of financial service restructuring, the debate has not been structured as one in which the users of financial services either have very much to say or have been a motivating force for **making** changes.

So in my own view, the issue of broadscale financial restructuring, while important, is for now politically impossible. That is why I think it important to go step-by-step and debate the issues involved in (1) setting forth the goals of financial reform, (2) correcting certain problems with the financial safety net, and (3) **picking** short-term objectives in congressional debate that stand a reasonable chance of success. In my own view, investment banking and commercial banking are the most closely linked of financial services. However, I admit that the joining of those two types of activity provides benefits mostly to the largest banking institutions and provides little in terms of new products or activities that might be beneficial to smaller banks or their customers, primarily because there are certain economies of scale in investment banking.

Functional regulation and insulation

I would next like to comment on two aspects of Huertas' paper. The first issue is functional regulation. The second is the type of mechanisms that may be desirable to insulate banking institutions from **nonbanking** affiliates.

Functional regulation is a term that joined the deregulation debate only two or three years ago. The idea, as I understand it, is that each component of a financial services holding company would be regulated by the "appropriate regulatory authority": banks by banking agencies, investment firms by the Securities and Exchange Commission, insurance companies by various state regulators, etc. There would be no regulatory agency that would look at all parts of a holding company. If there were an overseer, I suppose we could still debate expansion of bank holding companies' powers rather than financial service holding companies. At any rate, part of the rationale of these proposals is that in an appropriately regulated system there need not be a regulator of last resort. There may, in fact, be another reason for the functional regulation proposals: a desire to remove the Federal Reserve, viewed by some as an "unfriendly regulator," from the regulatory structure while permitting various affiliates to deal with only one regulator. The opposition to a regulatory authority overseeing the holding company seems to hinge on independence. While functional regulation is a system used by some countries, it may not be a system that would work very well here unless greater independence of our regulatory agencies can be obtained.

Independence of regulation is something to be cherished. Every time we have had an example of a regulatory agency being too close to its constituents we have had problems. So I view the role of the Federal Reserve, or another independent regulatory body, as the overseer of the bank holding company or the financial services holding company as extremely important.

Let me provide an analogy. In a university setting each academic discipline may have an independent department that pretty much controls its curricula and its requirements for graduating with a major in that department. However, the university structure also contains certain requirements that generally must be met for students to receive a degree from the university, with the degree signifying that all parts of the student's education have been fulfilled satisfactorily.

For the holding company, the requirements for a satisfactory rating by the regulators is important for each affiliate and for the parent as well. The market will value the worth of the holding company, but market analysts reach their opinion by **looking** at the whole and component parts—especially if market discipline is not fulfilling its role because of such things as the federal safety net.

In terms of insulating different parts of a holding company from the bank, I think Huertas has done an excellent job in making the point and summarizing some options. He has outlined the importance of the current system of insulation, Section **23A** (and now Section **23B** as well), antifraud and antitrust regulation, antitake-in provisions, etc. He has also drawn out of the various restructuring proposals innovative ways to increase the separation between elements. Those that he sets forth in his summary list could go a long way toward adding a degree of comfort to Congress and the regulators. However, I think he is overly optimistic that Congress would give broad authority of the regulator to frame the **rules** as he proposes.

There are other types of insulating factors, particularly complete prohibitions, that should also be considered if banking and financial activities are to be fully joined. **Tobin** points to some that are very compelling. For example, as **riskier** types of financial services are combined with banking, Congress should consider whether lending to affiliates should be either cut back or prohibited. Likewise, bank loans to issuers of securities underwritten by a securities affiliate should either be completely prohibited, as Kaufman recommends, or limited in the aggregate, as **Tobin** suggests. Otherwise, conflicts of interest and self-dealing are clearly a possibility, and unsafe and unsound financial practices may ensue, a point made at yesterday's session by Charles Freedman from the **Bank** of Canada.

Access to the payments mechanism is also an area where insulating safeguards may be insufficient. I am somewhat interested in the proposal made by Gerald Corrigan for a National Payments Clearing Corporation that would require participation by all users of the large dollar electronic payment systems.

There should be concerns when financial institutions own "captive" **banks** that they use to provide services to the **nonbanking** affiliates of the holding company, but which offer no or few services to the general public. Such captive financial institutions clearly are set up for purposes other than those we generally think of when we

use the term depository institutions. Permitting access to the payments mechanism by nonbank affiliates through such **banking** affiliates avoids a critical layer of independent credit judgment that is now fulfilled by the commercial banking system. Prudence requires that access to a large dollar payments system should require credit judgment by independent third parties. Huertas recommends that that could be taken care of by third-party guarantees or by the posting of collateral. Perhaps, but I am not sure. The issues could be mitigated if all daylight overdrafts were phased out, or alternatively, if daylight overdrafts were defined as commercial loans, priced, and made subject to Section **23A** restrictions.

At any rate, I think that proposals for insulating banks or insured depository institutions from noninsured financial affiliates is a critical issue. The answer lies somewhere between strengthening the insulating factors as Huertas recommended and absolute prohibitions as recommended by **Tobin**.

In conclusion, let me say that both of these papers are instructive. I think that **Tobin's** analysis of the safety net and deposit insurance is on target and something that Congress must address before making broad decisions on financial restructuring or even narrow decisions on the particular activities banks may undertake.

Finally, let me **reiterate** that I think the first step Congress should take is to reach an agreement on general goals of financial regulation. Then, the problems with deposit insurance should be corrected. Once those two things have been accomplished, a broad restructuring can be more rationally debated.