A Symposium Sponsored By
The Federal Reserve Bank of Kansas City

RESTRUCTURING THE FINANCIAL SYSTEM

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Contents

Foreword

The structure of the U.S. financial system, inherited from the regulatory framework set up in the 1930s, is being eroded by developments in global financial markets. Securities firms are increasingly engaging in activities traditionally reserved for banks and thrifts, while banks and thrifts increasingly look to be involved in securities, insurance, and real estate activities. The character and pace of change have led to a growing consensus that the current regulatory framework is no longer appropriate. There is much less agreement, however, as to the nature and scope of regulatory reform.

To provide a forum for the exchange of ideas on financial structure issues, the Federal Reserve Bank of Kansas City sponsored a symposium on "Restructuring the Financial System." This symposium, the eleventh in our series on major public policy issues, brought together leading authorities from academe, government, the Federal Reserve System, foreign central banks, and business to discuss these issues.

We hope these proceedings will be of interest to all those concerned about the future of our financial system. Grateful appreciation is extended to all those who participated in the symposium and especially to Gordon H. Sellon, Jr., Assistant Vice President and Economist in the Bank's Research Department, who helped develop the program.

ROGER GUFFEY
President
Federal Reserve Bank of Kansas City

The Contributors

E. Gerald Corrigan, President, Federal Reserve Bank of New York
Mr. Corrigan became president of the Federal Reserve Bank of New York on January 1, 1985. Prior to his appointment, Mr. Corrigan was president of the Minneapolis Federal Reserve Bank for four and one-half years. Mr. Corrigan's career in the Federal Reserve System began in 1968 when he joined the New York Fed as an economist after teaching economics at Fordham University. From 1968 to 1976, he served in a variety of staff and official positions at the New York Fed. In 1979, he left the New York Fed to become special assistant to Federal Reserve Board Chairman Paul Volcker in Washington, D.C. In August 1980, he became president of the Federal Reserve Bank of Minneapolis.
Mr. Corrigan is a trustee of Macalester College, Fordham University, Fairfield University, and the Joint Council on Economic Education. He is also a member of the Council on Foreign Relations and the Trilateral Commission.

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Mr. Edwards is director of Columbia University's Center for the Study of Futures Markets, and a professor at the Graduate School of Business of Columbia University. Mr. Edwards has been a member of the faculty of the Columbia Business School since 1966 and served as vice dean of the school from 1979 to 1981. Prior to joining Columbia University, Mr. Edwards worked at the Board of Governors of the Federal Reserve System and at the Office of the Comptroller of the Currency in Washington, D.C. A member of the Shadow

Financial Regulatory Committee, he has been a consultant to a number of regulatory agencies in Washington and to financial institutions and law firms on matters relating to antitrust law and regulation. Mr. Edwards has published over 60 articles and testified before numerous Congressional committees.

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Mr. Eisenbeis is presently the Wachovia Professor of Banking in the School of Business Administration at the University of North Carolina and a consulting associate with Furash and Company in Washington, D.C. He is also a member of the Shadow Financial Regulatory Committee. Mr. Eisenbeis previously served as senior deputy associate director in the Division of Research and Statistics at the Federal Reserve Board, where he served as the senior officer in charge of basic research and policy analysis of micro banking issues. He also has held positions at the Federal Deposit Insurance Corporation where he was assistant director of research and chief of the Financial and Economic Research Section. He has authored more than 40 articles in professional journals and is co-author of five books.

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Mr. Freedman was appointed to his current position in 1984. As advisor, his responsibilities lie principally in the areas of monetary policy and financial structure. Mr. Freedman joined the Bank of Canada in 1974, serving as research advisor in the Research Department and chief of the Department of Monetary and Financial Analysis. Before joining the Bank of Canada, he spent five years on the faculty of the University of Minnesota. Mr. Freedman is a research affiliate of the National Bureau of Economic Research and has written articles in the areas of macroeconomics, international finance, monetary policy, and the financial system.

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Mr. Kane presently occupies the Everett D. Reese Chair of Banking and Monetary Economics at Ohio State University. Previously, he taught at Boston College, Princeton University and Iowa State University. Mr. Kane is the author of two books and numerous articles in professional journals on the subjects of financial markets and financial market regulation. He has consulted widely with federal regulatory agencies, professional associations, Congressional committees, and executive agencies. A research associate of the National Bureau of Economic Research and a member of the Shadow Financial Regulatory Committee, Mr. Kane is also a past president of the American Finance Association and a former Guggenheim Fellow.

Henry Kaufman, Managing Director, Salomon Brothers
Mr. Kaufman is managing director and member of the Executive Committee of Salomon Brothers, where he is chief economist. Before joining the firm in 1962, Mr. Kaufman was in commercial banking and served as an economist at the Federal Reserve Bank of New York. He was admitted as a general partner of Salomon Brothers in 1967 and was appointed to the Executive Committee in 1972. Mr. Kaufman is chairman of the Executive Committee and a member of the Board of Trustees of the Institute of International Education, co-chairman of the Economic Council of the United Nations Association, and a member of the Board of Directors of the United Nations Association.

Robert E. Litan, Senior Fellow, The Brookings Institution

Mr. Litan is a senior fellow in the Economic Studies Program of The Brookings Institution, where he is also co-director of the Institution's new Center for Economic Progress and Employment. Mr. Litan is also counsel to the Washington, D.C. office of Powell, Goldstein, Frazer & Murphy, an Atlanta-based law firm. He is the author of several books and articles in professional journals on trade, banking, and regulatory policies.

Anthony D. Loehnis, Executive Director, Bank of England

Since 1981, Mr. Loehnis has served as executive director of the Bank of England, in charge of overseas affairs. He previously served the Bank as associate director and chief adviser. He was associated with J. Henry Schroder Wagg & Co. Limited from 1965 to 1977 and 1979-1980, as deputy head of the Company Finance Division. He served in Her Majesty's Diplomatic Service from 1960 to 1966, serving in Moscow and in London, dealing with the USSR and East European communist countries. He has been a member of the Group of Thirty since 1986.

Steven M. Roberts, Principal, Peat Marwick Main & Company

Mr. Roberts currently serves as a principal for Peat Marwick Main & Company where he is responsible for development of the firm's Financial Institution, Legislative and Policy Consulting Practice. Previously he served for three and one-half years as assistant to the chairman of the Board of Governors of the Federal Reserve System. From 1981 to 1983 he was vice president of government affairs for the American Express Company. He was chief economist for the U.S. Senate Committee on Banking, Housing and Urban Affairs from 1977 to 1981. From 1970 to 1977 he was senior economist in the Division of Research and Statistics at the Board of Governors of the Federal Reserve System. Mr. Roberts was the Federal Reserve staff representative on the Task Group on the Regulation of Financial Services Industry in 1983-1984. From 1972 to 1977, he served as adjunct professor at the University of Maryland.

L. William Seidman, Chairman, Federal Deposit Insurance Corporation

Mr. Seidman became chairman of the FDIC in 1985. At the time of his presidential appointment, he was dean of the College of Business at Arizona State University, where he founded the Institute of Business Leadership. Mr. Seidman was vice-chairman of the Phelps Dodge Corporation from 1977 to 1982. He was President Ford's assistant for economic affairs from 1974 to 1977. He was managing partner of Seidman & Seidman, Certified Public Accountants from 1968 to 1974. He was special assistant for financial affairs to the Governor of Michigan from 1963 to 1966. At Arizona State he was responsible for the operation of the University's Economic Outlook Center and its widely-acclaimed statistical report. In Arizona, he was also chairman of the Governor's Commission on Interstate Banking.

Yoshio Suzuki, Director, Institute for Monetary and Economic Studies, Bank of Japan

Mr. Suzuki was named to his current position as director of the Institute for Monetary and Economic Studies in 1984. Mr. Suzuki first joined the Bank of Japan in 1955. He was appointed chief of the Domestic Division of the Bank's Economic Research Department in 1976 and in 1981 was named deputy director of the Bank of Japan's Monetary and Economic Studies Department. He has served as a visiting lecturer at Tokyo University and Shinshu University. Mr. Suzuki is the author of numerous books and articles on monetary policy and financial market deregulation in Japan. He received the Nikkei Cultural prize for Economic Literature in 1967; the Economist's Prize from Mainichi Newspaper Company in 1975; and the Public Finance Fellowship from the Institute of Fiscal and Monetary Policy, Ministry of France in 1987.

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Mr. Tobin is currently the Sterling Professor of Economics at Yale University where he has been a faculty member since 1950. Since 1955, he has been a member of the research staff of the Cowles Foundation for Research in Economics at Yale. In 1961—1962, he served as a member of the Council of Economic Advisors. Mr. Tobin was president of the Econometric Society in 1958, president of the American Economics Association in 1971, and president of the Eastern Economics Association in 1977. He was awarded the John Bates Clark Medal for the American Economic Association in 1955. In 1981, he received in Stockholm, the Prize in Economic Science established by the Bank of Sweden in memory of Alfred Nobel. A member of the National Academy of Sciences, Mr. Tobin is the author or editor of 11 books and more than 200 articles. He has served as a consultant to the Federal Reserve System, the U.S. Treasury, and other governmental agencies.

The Moderators

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Mr. Meltzer is currently serving as the John M. Olin Professor of Political Economy and Public Policy at Carnegie-Mellon University. He has had frequent assignments with Congressional committees, as a consultant to the President's Council of Economic Advisers, the U.S. Treasury Department, the Board of Governors of the Federal Reserve System, and to foreign governments and central banks. Currently, he is honorary adviser to the Institute for Monetary and Economic Studies of the Bank of Japan. Dr. Meltzer is a founder and co-chairman of the Shadow Open Market Committee and a member of the Shadow Financial Regulatory Committee. His writings have appeared in numerous journals, and he is the author of several books and more than 150 papers on economic theory and policy.

Frederick H. Schultz, Former Vice Chairman, Board of Governors of the Federal Reserve System

Mr. Schultz is currently a senior advisor to Drexel Burnham Lambert, Inc. and serves as a director of the Barnett Banks of Florida. From 1979 to 1982, Mr. Schultz was vice chairman of the Board of Governors of the Federal Reserve System. Prior to his service on the Federal Reserve Board, Mr. Schultz was chairman of the board of Barnett Investment Services Inc. and the Florida Wire and Cable Company. Mr. Schultz also served as a member of the Florida House of Representatives from 1963 to 1970 and was Speaker of the House from 1969-1970. Mr. Schultz is a former Kennedy Fellow at the Harvard University Institute of Politics and is currently a member of the advisory committee of the Woodrow Wilson School of Public and International Affairs at Princeton University.

Introduction

Gordon H. Sellon, Jr.

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

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

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

Gordon Sellon is an assistant vice president and economist at the Federal Reserve Bank of Kansas City

To promote a better understanding of the issues involved in financial reform and the policy alternatives, the Federal Reserve Bank of Kansas City sponsored a symposium entitled "Restructuring the Financial System" on August 20-22, 1987. At this conference, distinguished academics, regulators, and financial industry representatives examined the need for financial reform and debated the merits of various proposals for restructuring the financial system.

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

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

As background for understanding the issues raised at the symposium, the remainder of this introduction focuses on two topics: the need for financial restructuring and a summary of the principal points of contention among program participants.

The need for financial reform

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

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

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

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

Issues in the,restructuring debate

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

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

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

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

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

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

Can Regulatory Reform Prevent The Impending Disaster in Financial Markets?

Franklin R. Edwards

Introduction: An aura of uneasiness

A deep current of unrest flows through financial markets these days, carrying with it a feeling that things are, in some way, out of kilter. While no one is quite certain of the precise reasons for it, there is a general uneasiness about whether the fabric that binds and solidifies our financial system is coming unraveled. In recent years, we have witnessed spectacular bank failures (such as the Continental Illinois bank), seen the collapse of two state deposit insurance systems, and been told that the prestigious Federal Savings and Loan Deposit Insurance corporation (FSLIC) is in the red by some **$30** billion. Newspapers carry daily stories of the billions of dollars of loans made by banks to third-world countries that will never be repaid, but will have to be written off as bad debts. Banks and thrifts located in areas dependent upon the health of the energy and farm sectors are in deep trouble; many will fail. The total number of bank failures this year has already surpassed historical annual highs. Even the future of the mighty Bank of America is in doubt.

Intertwined with this shaken financial structure is the world of glittering high finance, where the successful (and the dishonest) amass large fortunes in only a few months or, at most, years, and where success is expected to come early to the best of our university graduates. A seemingly endless stream of innovations—swaps, coupon-stripping, futures, options, leveraged-buyouts, and so forth—occupy the attention and the resources of our best institutions. In this world, internationalization, global capital markets, and 24-hour trading are the vogue. In the lowly world of banks and thrift institutions we are still debating the feasibility of permitting Citibank to operate in New Jersey, or Illinois, or Texas, knowing full well that it already operates in every major country of the world. In high finance, anything is possible and nothing seems prohibited, while in the other world banks and traditional financial institutions seem entrapped in a static environment encumbered by archaic regulation. It is little wonder that these inconsistencies and the resulting pervasive bickering among financial market participants and regulators have begun to make us question the logic of the current financial structure and to ponder whether regulators are still playing a constructive role in guiding market developments.

Concern about the stability of the financial system is also being reinforced by persistent macroeconomic disequilibria. A continuing government budget deficit threatens us with uncertainty about debt markets and interest rates, and persistent trade imbalances have wrought currency instability and a threat to free-trade relationships. The recent behavior of the stock and bond markets is testimony to this unrest. More volatile than at any time in recent history, these markets epitomize the fragile nature of expectations about the future. We seem to be balancing on a knife-edge of stability, ready to be toppled one way or the other by economic or political news that either reinforces or shakes our view of the future.

The world is changing around us, in spite of us, and there is no clear path or end in sight. We have a financial system born in the 1930s in the depths of our greatest economic catastrophe, formulated and promoted as the fail-safe system of the future. Pictures of bank failures and bank runs, with their long lines of dispirited and desperate people, provide a vivid reminder of the intimate relationship between our economic health and the soundness of our financial institutions. More than 50 years have gone by since the collapse of the 1930s, years of relative calm and prosperity. During those years, our financial system, while buffeted by occasional shocks and imbalances, performed admirably. Financial institutions of every type blossomed.

The idea that this system may in some way be seriously flawed is an alien thought. The notion that it should be drastically changed shocks us. "If it works, don't change it" is a philosophy that needs no proselytizing. But the world is changing, and our financial system is no longer working well. Worse, it is failing in ways that are not immediately obvious, giving us a false sense of comfort. The seeds of change, planted in the 1960s, have long ago sent their shoots into every comer of the financial landscape. Institutions are being entangled and will eventually be smothered unless the financial system is restructured to accommodate these changes.

Change, of course, is never easy, and changing something that has been almost sacrosanct for more than 50 years is an intimidating prospect. With longevity and prosperity come strong private-interest groups. We have done our best to nurture a system of heterogeneous institutions, insulating and protecting them from one another with the heavy hand of regulators. Institutions have responded predictably: where similar interests are at stake, they have banded together to form powerful special-interest groups, besieging Congress and regulators either for special privileges or to block intrusions into their preserves. Special-interest groups are the natural predators of change. When threatened by it, they erect still more formidable barriers to contain it.

This political-economic process is presently playing itself out, to the detriment of the entire country. The winds of change embracing us are seeping through the hastily erected barriers faster than they can be built. Once breached these barriers will crumble with electrifying speed, taking with them in a crash many institutions that appear sound today but are in reality teetering on the edge of instability.

It is important that we not allow this to happen; that we orchestrate this change, and not allow it to crash down upon us with unpredictable consequences. We have a governmentally-constructed and regulatory-maintained financial edifice, one that is not the product of natural market forces. It is a system neither prepared nor capable of coping with the market changes inundating us. We cannot close our eyes to its fate without serious risk.

The time has come,for us to reach a consensus. We must determine the financial system of the future and put in place a compatible regulatory system. Barriers that prevent us from achieving these goals, or that threaten present stability, must be quickly dismantled, and regulations needed to assure financial soundness either retained or developed. There must also be provisions made for transitional problems that will be encountered in moving from an old to a new system.

A key to accomplishing this is to identify and discard myths that have been a continual obstacle to the restructuring of the financial system. Another critical step is to agree on fundamental goals of financial regulation and on the nature of government intervention that is needed to achieve these goals. Finally, we need to commit to a financial system that provides for the maximum degree of free-market discipline for our financial institutions, consistent with a stable financial environment.

These objectives may seem like a tall order to those of us who have long been enmeshed in the complex maze of financial regulation, but I believe there is more agreement among us than is commonly either realized or acknowledged. A first step is, therefore, to identify key principles and concepts on which we agree or disagree. Such an understanding is fundamental to establishing a firm foundation upon which to construct a new regulatory structure.

Why we must act

We must act soon. We are sitting on a ticking time-bomb with an uncertain timing device. Most of you will find this declaration startling, even unbelievable. Things do not seem that bad! True, some institutions are going bankrupt, but most are operating in the black. How can conditions be that threatening?

The situation today is similar to the rotting frame of an old house. Each piece of supporting timber has rotted from the inside. From casual observation, it is impossible to determine whether the supports are sound. A few probes with a sharp instrument, however, quickly reveals that the timber has rotted, its ability to support the house gone. Despite this enfeebled condition, the house miraculously stands, until one day a brief but intense gust of wind takes it down with a crash.

Is this an alarmist analogy? Yes. Does it misrepresent the current situation? I do not think so. The reason appearances today do not reflect reality is due to a combination of deposit insurance, fictitious accounting, and regulatory procrastination.

The deposit insurance crisis, and that is what it is, is increasing with every passing month. It is not a secret: almost everybody knows, even Congress. But its resolution is not a simple matter.

The insurance crisis is gathering in force because the numbers are getting larger.[1] We already know that the FSLIC is some $30 billion short. Were it to close only those thrift institutions it knows to be already insolvent and to repay depositors, it would need at least $30 billion more than it now has. Its solution, therefore, has been not to close these institutions, but to pretend that they are not insolvent.

This is not a neutral policy. It does not simply maintain the status quo; it makes things worse. The managements of the insolvent institutions have almost nothing more to lose. They have already lost their institutions, for all practical purposes. But they still have some of the deposits of their customers, and the hope that a miracle will revive them. It is a small step for them to try to help this miracle along by their taking a last, desperate gamble with their depositors' funds.

Football fans call this the "long-bomb" phenomenon. In a football game, with time running out, the team that is hopelessly behind begins to resort to the high-risk, seldom successful play—a long pass into the opponent's end zone. There is always a small chance that it may work!

In a football game, the failure of this "long-bomb" strategy is of little consequence: they would have lost the game anyway. It is there that the analogy with today's thrift crisis ends. The consequences of a failing thrift institution unsuccessfully pursuing such a high-risk strategy are serious: the institution goes deeper under water and its depositors are at greater risk. The institution's assets shrink even more, making the imbalance between its assets and liabilities greater. When the institution is finally declared insolvent, the FSLIC has an even bigger bill to pay. It must refund insured depositors their monies, using more of its own (and taxpayers') resources to do it.

Why would depositors leave their funds with insolvent institutions and be vulnerable to "long-bomb" risk-taking? Because, of course, they are insured by the government, and are confident that whatever the outcome they will be repaid by the government.

Thus, we have the makings of an escalating crisis. FSLIC, without adequate resources, is unable to close already insolvent institutions, but at the same time is unable to control risk-taking by these institutions. In addition, these institutions have every incentive to take even

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[1] See Edward J. Kane, *The Gathering Crisis in Federal Deposit Insurance.* Cambridge: MIT Press, 1985

more risk, and ultimately, to fall deeper into debt. FSLIC's debt is steadily mounting. It is a matter of time before thrift depositors understand this too and begin to wonder about either the ability or the resolve of the government to stand by its guarantees. When this happens you have the classic "bank-run": depositors will indiscriminately remove their funds from solvent as well as insolvent thrifts, since they will not be able to distinguish one from the other.

This threat may extend to banks as well, and not only to thrift institutions. Those with deposits at banks look to the Federal Deposit Insurance Corporation (FDIC), just as thrift depositors look to the FSLIC. How good is the FDIC if the FSLIC has been let fail? Past decisions by depositors and other investors have been made on the basis of our present financial and regulatory structure. Deposit insurance and government guarantees are an integral part of this structure. Any loss of confidence in these guarantees risks serious repercussions for all institutions.

Congress is fiddling while risk is mounting. At best, it will eventually bail out our insurance funds, imposing a tremendous cost on taxpayers. At worst, it will do nothing until we have a panic on our hands. In either case, it will be acting irresponsibly late.

The growing insurance crisis is exacerbated by our antiquated accounting conventions and by the present regulatory policy of increasing "forbearance." The health of many financial institutions today is illusory. Their asset values reflect inflated historical values and not actual current market values. Their equity values are commensurately overstated. There is little doubt that were we to restate assets and liabilities on the basis of sensible market-value accounting principles, many financial institutions would become insolvent overnight.

The absence of realistic accounting conventions also causes regulators to defer acting even when they know they should. Instead of closing institutions early, when losses to the insurance fund (and taxpayers) are minimal, they defer action, hoping either for a miraculous recovery or that such action may be postponed until they are no longer in office. Were the balance sheets of institutions to reflect realistically their weakened condition, regulators would undoubtedly be under greater public and congressional pressure to act. Even depositors, despite the insurance guarantee, might begin to view with a jaundiced eye the wisdom of lending funds to insolvent entities. Better accounting means better information, and with better information the rot would be discovered and remedied before it could threaten the safety of the entire house.

The current policy of increasing regulatory forbearance (or forgiveness) is ill-advised. While its equity objectives are understandable, perhaps even laudable, it is dangerous and doomed to failure. The basic assumption underlying this policy is that future changes in the economy will occur that will rescue troubled institutions. Energy-troubled banks will return to good health when energy prices go back up, making the energy sector prosperous again; or, farm-troubled institutions will recover when farming does. In the meantime, losses are mounting.

Regulatory forbearance can work, and sometimes has worked, but it will not work this time. While some of our current problems are of a cyclical nature, the most critical ones are not.. They are the result 'of structural changes in financial markets. These changes will be permanent features of the future financial landscape. They are not ephemeral fissures in the existing structure.

A major change has been the erosion of barriers to competition, which separated financial institutions and markets from each other. Deposit insurance, instituted during the 1930s as a supplement to the Federal Reserve, was directed at protecting small depositors, preventing bank runs, and protecting the payments system from disruption. In return for this federal guarantee and as a safeguard to the federal deposit insurance system, depository institutions were wrapped in protective regulation, which they accepted as a necessary component of the system. It was, if you will, a regulatory (or government) fostered cartel, complete with rigid entry barriers and regulations to prevent "destructive" competition. (An example was the interest rate ceilings imposed on deposit accounts.)

The result was to create an artificial financial structure characterized by thousands of small disparate financial institutions. We had institutions specializing in only mortgage loans, or consumer loans, or business finance, or trust services, and so forth. We had banks with thousands of branch offices, while others were prohibited from opening an office across the street from their main office. We had thousands of tiny institutions operating in insulated local markets, where competitors were unable to go, together with giant institutions operating in distant cities, like they were on different planets of the solar system. We had U.S. institutions doing in London and Frankfurt what they were prohibited from doing in New York and Chicago, and foreign banks doing in New York and Chicago what U.S. banks could not do in the United States. It was a regulatory-created and nurtured edifice, not the child of natural market phenomenon, and it could only be sustained by protective regulation.

Economics, technology, and competitive developments combined to tear down these protections. What is left is deposit insurance and government guarantees without the regulatory safeguards designed to support them. High and volatile interest rates (and therefore funding costs), sharply reduced information and communication costs, and the globalization of capital markets together with intense international competition have all played a role in eliminating competitive barriers. Interest rate ceilings on deposits have been removed, opening up competition for funds; the geographical operations of institutions has widened substantially; there has been a frantic search for new sources of earnings and ways of diversifying, which has led to U.S. banks going off-shore and to the development of the Eurodollar market and foreign financial centers. Most of all, the new world of open competition has destroyed the cartel-like world of old, threatening the viability of many of the formerly insulated financial institutions.

Discarding old myths

A first step in moving to a new and more sustainable system is to discard certain myths that have prevented us from undertaking significant regulatory changes. These are false beliefs about what are necessary features of a financial system, about the role of government intervention, about regulation and its costs and effectiveness, and about what are necessary safeguards against a costly financial collapse.

Myth 1: Deposit insurance is necessary for financial stability.

Deposit insurance will undoubtedly be a central element of any new financial structure. It has occupied such a position for the last 50 years, and is understandably viewed as essential to a well-functioning and stable financial system.

Deposit insurance has had twin goals: to protect small depositors and to prevent bank runs. Its role as preventor of bank runs is seen as being integral to financial stability. Without it, what would prevent depositors, fearful of bank insolvencies, from engaging in the wholesale withdrawal of funds from the banking system? This view has led in recent years to the continued expansion of defacto (if not *de jure)* deposit insurance coverage, to where today such coverage may be as great as 100 percent of a bank's liabilities.

It is a falsehood that deposit insurance is necessary for financial stability. Indeed, under certain conditions, such as we have at present, it may even contribute to instability. Proof that deposit insurance is unnecessary is everywhere: many countries, both today and historically,.have enjoyed financial stability without having a system of deposit insurance. While it is true that the financial structures of many countries are quite different from ours, the point remains valid: as a general proposition, deposit insurance is not required for stability. There is, in addition, little evidence to indicate that under normal market conditions a bank failure (or failures) will precipitate a run on depository institutions.

The primary safeguard against bank runs and financial panics is, and has always been, the central bank, with its unlimited lender-of-last-resort capability. Used intelligently and judiciously, this power is all that is needed to protect us against irrational and episodic financial panics. Deposit insurance is superfluous.[2]

As a country, we turned to deposit insurance out of distrust of the Federal Reserve. The Federal Reserve failed us miserably in the 1930s and, as a consequence, deposit insurance was adopted as the panacea. Deposit insurance would presumably remove the human element: we would not have' to rely on the discretionary judgment of central bankers but could depend instead upon a failsafe institutional structure.

In reality, we substituted one set of regulators for another. We put our trust in regulators assigned to administer and protect the deposit insurance system, rather than in central bankers, and these regulators are failing us in the 1980s just as the Federal Reserve did in the 1930s. By failing to act and by following an expanding policy of regulatory forbearance, regulators are failing to protect our insurance system

[2] See Anna J. Schwartz, "Financial Stability and the Federal Safety Net," unpublished, prepared for the American Enterprise Institute's project on Financial Services Regulation, 1987

and are sowing the seeds of a financial disaster. In the end, it will be the Federal Reserve on which we must rely.

If there is a role for deposit insurance in the future it is as a guarantor of small depositors. The rationale for such a role is one of "social justice" rather than "economic efficiency." We might want to consider retaining some deposit insurance for this purpose, as long as its coverage can be kept narrow. For the purpose of financial stability, however, deposit insurance should be discarded in favor of a more pervasive central bank role as lender-of-last-resort. Once this is done, a number of promising avenues for financial reform will be open to us.

A lender-of-last-resort policy also will not be subject to the same moral hazard problem that has undermined deposit insurance. The primary objective of the central bank should not be to rescue individual institutions but to provide market liquidity (through, for example, open market operations). If institutions are in general solvent, the provision of ample market liquidity should be adequate to prevent bank runs. The task of assuring institutional solvency should not fall to either the central bank or deposit insurance, but rather should be the result of a soundly conceived and maintained financial and regulatory structure. If there is pervasive institutional insolvency, not even the Federal Reserve can help.

If direct central bank lending to individual institutions were to become necessary, it also would not carry with it the same predictable and dependable subsidies as has deposit insurance. It would not, for example, result in a continuous divergence between what institutions pay for funds and what they should pay. Managers could not as easily internalize in everyday decisions the mere possibility that central bank funds might be forthcoming as they can the deposit subsidies on their funds.

Myth 2: Bank failures and financial instability are the same.

It is often thought that bank failures cannot be permitted without endangering the entire financial system. Similarly, bank failures are equated with high social costs. These are inhibiting notions. They keep regulators from closing banks when it would be prudent to do so.

Bank failures need not mean market disruption, or even customer disruption.[3] They can very often be accomplished by simply replacing old owners with new owners, where the losses are borne by the old owners. This is possible if regulators close banks in a timely manner, or before the market value of their equity is less than zero. The longer regulators wait to act, the more difficult it is to find new owners, and the higher the social costs.[4]

Bank failures (as well as the failure of other financial institutions) should be expected. They are an essential part of a competitive world. Competition without failure is anomalous. Failures are part of the engine that makes competition work. They must be anticipated and planned for. When that is done, bank failures and financial instability are not synonymous.

Myth 3: *Effective* monetary policy requires *narrowly-defined* banks.

An old obstacle to restructuring the financial system is the view that monetary policy cannot work unless the payments system is controlled by narrowly-defined banks. The argument is sometimes couched in terms of the uniqueness of the money supply and the necessity of regulatory-mandated minimum reserve requirements. In recent years, there has been a blurring of what constitutes "money" (or "transaction" balances), and of which institutions are providing (or should provide) such balances. The fear is that if these balances are not concentrated in "banks", or other commensurately regulated entities, the Federal Reserve will no longer be able to control the "money supply."

This fear is unfounded. The Federal Reserve is capable of controlling the monetary base, whatever the financial structure. The need for mandated reserve requirements is also questionable, although in principle they could be imposed on any institution (not only banks). Finally, there is no clear association between different types of financial structures and either the stability of the money supply or a central bank's ability to control money. In addition, there is evidence that the maintenance of artificial (or regulatory-induced) capital market

3 George Benston and George Kaufman, "Risk and Failures in Banking: Overview, History, and Evaluation," in George Kaufman and Roger Kormendi, eds., *Deregulating Financial Services.* Cambridge: Ballinger, 1986.

4 George Benston and George Kaufman, "Risk and Solvency Regulation of Depository Institutions," unpublished, prepared for the American Enterprise Institute's project on Financial Services Regulation, 1987.

barriers between different kinds of financial institutions and markets may inhibit effective monetary control. Our experiences with Regulation Q taught us this lesson well.

Thus, monetary policy can be effective even if "banks" are not the only providers of "money." The goal of effective monetary control cannot be used to justify a regulatory policy that mandates narrowly-defined banks.[5]

Myth 4: The separation of banking and securities activities is necessary for financial stability.

There are many arguments about why banking and securities activities should or should not be mixed. Some of these should be taken seriously; some should not. One that should not is that the mixing together of such activities will undermine the soundness of our financial system.

There is little dispute that, in principle, mixing banking and securities activities provides financial firms with greater diversification opportunities, which should enhance profitability and risk management. This should contribute to greater financial stability, not less. The empirical evidence that we have on banks suggests that greater diversification is valuable. Similarly, there may be economies of scale and scope that can add to profitability.

The major arguments against mixing banking and securities activities are potential abuses related to perceived conflicts-of-interests and to the "upstreaming" (or transferring) of profits or assets from the bank to associated entities, thereby weakening the bank. These arguments are related more to the corporate form employed—the holding company entity—than to the mixing of banking and securities activities. There is nothing inevitable about the holding company form of organization. It is also not obvious that abusive "upstreaming" practices by–holding companies cannot be controlled.

Stripped of this controversy, there is nothing unique, or intrinsic, to securities activities that make them inherently dangerous for banks. They are not, for example, more risky. Nor do they pose conflicts-of-interest problems more severe than already exist in many bank-

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5 See Marvin Goodfriend and Robert King, "Private and Central Bank Provision of Liquidity," Ibid., 1987.

ing and securities firms. Further, by permitting more open competition among banks and securities firms there should be less abuse of conflict situations in the future.[6] Finally, other major countries have permitted the mixing of banking and securities activities without undermining the soundness of their financial systems. Indeed, our own banks have done a securities business abroad for years without adverse consequences.

Myth 5: The payments system requires the separation of banking from commerce.

Some have argued that unless banks are kept "pure", free of the risk associated with commercial activities, there will be an unacceptable risk of "settlement failure" in our payments system. This argument largely reflects concern about the private "wire transfer" segment of the payments system and, in particular, about CHIPS. CHIPS is an electronically-linked network of over 130 large banks that processes about 90 percent of the international interbank dollar transfers.

It is feared that the failure of a single CHIPS bank to settle at the end of the day may generate a systemic risk of widespread failure, with a result similar to a bank run. A settlement failure may have a chain reaction, rendering some banks temporarily illiquid and others possibly even insolvent (which may occur if creditor banks are ultimately not able to collect a substantial percentage of what they are owed from the bankrupt institution). Such systemic risk is not present to the same degree in the Fedwire system because the Federal Reserve guarantees transfers when the receiving bank is notified of payment.

Settlement failures in wire transfers are logically quite similar to other credit risks that banks face. The only distinction is that daylight overdraft risks are concentrated among only the largest banks. There is, therefore, no "payments system risk" separate and distinct from the general issue of financial institution soundness. If mixing banking and commerce is in general unsound, it is also unsound from a payment system risk perspective. If such activity is not unsound,

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[6] See Anthony Saunders, "Bank Holding Companies: Structure, Performance and Reform," Ibid., 1987.

there is no special payment system risk problem. The only issue is the soundness of financial institutions.[7]

Myth 6: Small is "best."

The present financial structure is populated with thousands of small banks and financial institutions. Possibly as a result, it is sometimes thought that a system characterized by large financial institutions is not desirable.

Two fallacies underlie this view. First, the structure we now have is artificial: it is the child of regulation. It is a structure nurtured and preserved by restrictive regulation. Both geographic restrictions (such as branching prohibitions) and product restrictions (for example, banking versus securities activities) fostered and maintained this structure. Without them, it is doubtful that the financial structure would look anything like it does today. A quick glance at foreign countries confirms this: they have far fewer and relatively larger financial institutions. In addition, the current erosion of regulatory barriers to competition has had the predictable effect: reducing the number of institutions and increasing the size of those remaining.

Second, there is no evidence that a system with fewer and larger institutions is inferior. With fewer regulatory barriers, the general level of competition will increase, and not diminish, as is sometimes feared. Cost studies indicate that large banks are no less efficient than small banks, and there is no reason to think large banks pose a greater soundness problem. There is, finally, no reason to believe that a structure of fewer and larger banks (or financial institutions) creates additional problems with respect to conflicts of interest, the allocation of credit, or the exercise of political influence.

There is, therefore, no convincing reason to prevent market forces from working to alter our financial structure (governed, of course, by the enforcement of the antitrust laws). If the result is fewer and larger institutions, this may be "best." A structure of small, artificially protected, institutions is definitely not optimal.[8]

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7 See Mark Flannery, "Public Policy Aspects of the U.S. Payments System," Ibid , 1987.

8 See Franklin Edwards, "Consolidation, Concentration, and Competition Policy in Financial Markets: the Past and the Future," Ibid., 1987

Fundamentals of a new financial system

Discarding these myths does not by itself delineate the contours of a new financial system. It does free us to consider a broader range of possibilities. All of these alternatives, however, must satisfy, or be consistent with, a number of fundamental goals. Identifying these goals is essential to designing a new system and to defining the proper scope of government involvement.

There are four goals that any new financial structure should satisfy:

- A sound and stable financial system
- The most competitive system consistent with soundness and stability
- Equal (or fair) treatment of all customers
- Protection for the small and unsophisticated depositor

While it is beyond the scope of this paper to describe all of the features of a new financial system, a number of potential facets of such a system deserve consideration.

1. Deposit insurance should be restricted to protecting only small depositors. It should not be so pervasive as to insulate depository institutions from the forces of market discipline. A broad-based deposit insurance system should be avoided because it entails an unmanageable moral hazard.

2. The chief protection against bank runs and other systemic risk should be the Federal Reserve. It should use its lender-of-last-resort capability to prevent systemic problems due to illiquidity.

3. Competition should be encouraged by the removal of barriers preventing competition. In particular, nationwide branching should be adopted and financial institutions should be permitted to undertake a wide range of financial activities, including securities activities.

4. The general antitrust laws should be applied to financial institutions to prevent monopolization and unfair competitive behavior and should constitute the only competitive standard applicable to financial markets.

5. Efforts should be made to impose greater market discipline on financial institutions. The adoption of market-value based accounting principles is a first step, along with the public disclosure of an institution's performance.

6. Regulation to protect the safety and soundness of the financial system should be backed primarily by minimum capital requirements

and by a "closure policy" that closes institutions before they have zero or negative (market-value) net worth. Insolvent institutions should not be permitted to exist.

If these features were adopted as the centerpiece of a new system, it would be relatively simple to fill in the required additional elements.

Conclusion

This paper is a plea for action—an appeal to end the political paralysis that now immobilizes Congress and regulators. Twenty percent of all thrift institutions are now unprofitable, and more than 450 are already technically insolvent. It has been estimated that the FSLIC, which insures $900 billion in thrift deposits, is some $30 to $50 billion in the red, and everyday it does nothing taxpayers potentially lose another $10 million.

The banking situation is also deteriorating. About 200 banks are expected to fail in 1987, and the FDIC's list of problem banks has soared to 1,600, up from 218 in 1980. Intense competition from both bank and nonbank sources, and depressed conditions in certain economic sectors, such as energy and agriculture, threaten an even greater number. Large banks, finally, are faced with a steady erosion of earnings over future years by having to write off an increasing amount of the $300 billion owed to them by third-world debtor countries. The ability of even the FDIC to meet its potential future obligations is by no means assured.

If nothing is done, the situation will continue to worsen. At some point, public confidence in our financial structure will collapse with potentially devastating effects. To do nothing is to challenge fate. Such a course is politically and economically irresponsible.

There are a number of long-standing myths about what are essential characteristics or components of a sound financial structure that must be debunked before we can hope to reform our financial system. These are, as you would expect, time-honored postulates, but ones that nevertheless must be confronted before we can move forward. By focusing debate of these general concepts, we can avoid much of the myopic political in-fighting that unfortunately dominates all discussions of financial reform. This paper sets forth a number of mythical postulates that I regard as serious obstacles to reform. My intention, clearly, is to center debate on these longer-run principles rather than on more obvious turf-threatening conflicts.

A companion effort must also be made to agree on and to adopt general goals for regulation. These goals are often lost sight of in our effort to respond to current exigencies and to shore-up troubled institutions. Without having them to guide us, however, we are like a sailor without a compass: doomed to tacking back and forth aimlessly with only the slightest hope of finding the safety of solid land. I sketch out a number of general goals that I believe must guide our restructuring of the financial system.

In the coming months and years, Congress, regulators, and even the courts will be called upon to make decisions that will have far-reaching implications for the financial system and our economy. They must begin to develop a general blueprint to guide their way. Through debate, research, and discussion, such a blueprint can hopefully be fleshed-out to form a core of principles to guide us in creating a long-lasting, efficient, and sound financial structure.

Eroding Market Imperfections: Implications for Financial Intermediaries, the Payments System, and Regulatory Reform

Robert A. Eisenbeis

Introduction

Technology, financial innovation, and deregulation are breaking down market imperfections that were the raison de'tre for the existence of depository institutions. There have been many consequences for the structure of the financial system and the traditional role of depository institutions.

First, changes in communications and information processing and conceptual breakthroughs in the pricing of assets and contingent claims made possible the design, issuance, and distribution of financial instruments and services that would not have been feasible in earlier years. The sheer size and breadth of domestic and foreign financial sectors have enabled these new instruments to have ready markets. Moreover, many financial institutions now have offices worldwide and operate 24 hours a day, and because of technology and communications advancements, the financial activities of'these institutions move around the world as one market closes and others open. These developments have reduced the costs of liquefying assets, altered individual and corporate financial asset holdings, integrated foreign and domestic financial markets, and changed the underlying structure of how payments are made.

Second, rapid inflation, rising interest rates, and binding regulatory constraints provided rewards to those depository and nondepository institutions successful in innovating ways to arbitrage those regulatory constraints.[1] Thrifts have entered the transactions account and commercial credit business. Banks now offer a wide array of time deposit and mortgage instruments and have significantly broadened their securities activities. Nondepository institutions, such as finance companies, brokerage firms, money market mutual funds, and merchants, have begun to offer full ranges of financial services, including close substitutes for transactions services and commercial credit. The resulting increase in competition has narrowed spreads and reduced the profitability of many banking institutions.

Third, not only have the returns to banking declined but also the risks appear to have increased. For example, the wider array and increased complexity of activities conducted by individual institutions has increased operations risks. The large amounts of substandard and nonperforming loans suggests that credit quality has declined. Reduced profitability, especially when considered in conjunction with the increased volatility of interest rates, has increased the variability of earnings and is perceived to be threatening the viability of individual financial institutions and the system as a whole.[2] Finally, the rapid growth of large dollar payments and expanded daylight overdraft activity increase risks to the payments system and ultimately to the Federal Reserve as the primary creditor on Fedwire and the lender of last resort.

The changing nature of the industry has raised important concerns about threats to the viability of banking institutions and to the stability of financial markets and the payments system.[3] These fears have been given greater currency by the increased rate of bank and savings and loan (S&L) failures, the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC) and the increased exposure of the Federal Deposit Insurance Corporation (FDIC), the failure of Continental Illinois Bank, and the volume of underwater third-world debt

[1] See, for example, Kane (1981), Eisenbeis (1986)

[2] In a paper presented at last year's conference, I argued that many of the present signs of vulnerability were the legacy of past regulatory policies. See Eisenbeis (1986)

[3] In his discussion of the paper, Kane (1987) missunderstands the thrust of the second of the two main conclusions of the paper. It is not that the system has necessarily become more vulnerable. Rather, the point is solely that the public policy debate has gone forward as though the system has become more vulnerable. In fact, the key focus of this paper is on the assumptions that implicitly underly many current financial reform proposals, and it is argued that they do not capture adequately the present finanical system

in the portfolios of many of the major U.S. money center banks.[4] Additionally, the rapid growth of large dollar payments and expanded daylight overdraft activity increase risks to the payments system and ultimately to the Federal Reserve. These problems, fueled by banking industry frustrations with the current regulatory structure, which many believe is outmoded in today's competitive environment, and the perceived competitive inequities resulting from differential regulation of competitors have become major sources of pressure for regulatory reform.[5]

Recent reform proposals have attempted to address these problems, and some of these proposals are discussed in detail by Thomas Huertas (1987). Most start with several explicit or implicit premises and propose fairly minor changes in the existing structure. It is argued that banks and financial intermediaries remain unique, that they continue to play a special role in our economy as providers of transaction services and as sources of liquidity, that government has a fundamental responsibility to assure the safety and soundness of financial markets, and implicitly, that it remains possible to keep our domestic financial system essentially insulated from international markets.[6] This paper examines some of these premises in more detail in the hopes of provoking discussion and reexamination of their current relevance to regulatory reform issues. In some instances, overexaggeration is employed to help point out the implications of where the financial system seems to be evolving. It is only by these exercises that a clearer

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4 The rate of bank failures in 1987 is about at the 1986 rate, an all-time high except for the 1920s and 1930s. The recently publicized writeoffs of third world debt by most of the major money center banks and their posting of large second quarter losses are viewed as another symptom of the problems of vulnerability of the financial system Losses for the second quarter of 1987 are estimated to be over $10 billion These losses are due to more than problems in the foreign debt area. Institutions are reporting problems in their bond trading area, in nonperforming loans, and with rising expenses See Schmitt and Hill (1987)

5 As early as the Hunt Commission (1971) problems with the existing regulatory structure were being extensively explored and comprehensive, forward-looking reform proposals were suggested, but the commission's recommendahons were never given very serious consideration Subsequent studies, such as the House's FINE report, were followed by similar inaction. Meanwhile, market forces were significantly shaping the evolution of the system Piecemeal legislation has been enacted, most notably the Monetary Control Act of 1980 and the Garn-St Germain Act of 1982, which largely ratified these market developments

6 See, for example, Comgan (1986)

understanding can be gained of the implications of specific reform proposals.

The paper will first briefly examine the services that banks provide and the market imperfections that they address. Next, recent changes in the financial system and how they are eroding market imperfections are examined. Then the public interest in banking and the payments system will be examined in light of these changes.

It will be argued, first, that market developments are eroding the market imperfections that gave commercial banks their advantages over direct credit markets. Moreover, bank liabilities no longer perform their same unique functions in the nation's payments system. Therefore, any forward looking reform proposals must take these developments into account. Second, because of internationalization of the U.S. financial system and the ability of U.S. institutions to engage in structural arbitrage, one can no longer ignore the international considerations in the design of new reform proposals. It is no longer possible to constrain our domestic institutions through regulation without (1) creating opportunities for foreign institutions to achieve a competitive advantage in our domestic markets, (2) providing incentives for the domestic customers to seek lower cost alternatives abroad, and (3) driving our domestic financial institutions abroad, where they may be less constrained. Third, concerns for maintaining the safety and soundness of the payments system differ significantly from those that were relevant when the present regulatory structure was put in place. The existing structure was designed to protect the stock of money, and this was to be accomplished by preventing the failure of commercial banks whose liabilities were the primary component of the money stock. Today, the primary concern is assuring the integrity of the flow of payments through the payments system as financial assets are exchanged. Finally, if they are to be successful, forward looking reform proposals must take into account not only the existing financial and regulatory structure but also how the regulated institutions will respond to changes in regulations and regulatory burdens.

Market imperfections and financial intermediaries

In a world with perfect markets and no transactions costs, there would be no need for financial intermediaries or depository institutions. Assets would be perfectly divisible, and agents could costlessly seek out and exchange assets they held or services they provided for those that they needed. It is only when market imperfections, such as indivisibilities of assets, transactions costs, and asymmetric and costly information are recognized that the existence of financial intermediaries can be explained. Conversely, as these imperfections are reduced, transformed, or modified by changing market conditions and new technological developments, the economic advantages for certain financial intermediaries are modified.[7]

Contemporary finance theorists have identified a number of services that depository institutions provide:[8]

1) Portfolio management services. At low cost, holders of claims on financial intermediaries can acquire an interest in a diversified portfolio of claims on deficit spending units that they could not acquire in their own portfolios because of indivisibilities and transactions and monitoring costs.

2) Payments services. In the case of certain intermediaries (banks, thrifts, and others), they facilitate the transferring of ownership claims on assets among individuals by debiting and crediting the accounts of the intermediary. Here there are economies of scale in accounting, record keeping, and processing, and in the clearing and settlement of payments.

3) Risk sharing services. As an important and conceptually separable component of portfolio management services, financial intermediaries facilitate the distribution of risky income flows from the asset portfolio. Debt holders typically receive fixed payments or variable payments, and equity holders receive the residual. A whole class of insurance services are also included under the heading of risk sharing services. These would

[7] In his comment on this paper, Kane (1987) properly points out (1) that regulation can create market imperfections—though restricting arbitrage possibilities—Kane (1981) and (2) that government subsidies can be Important as regulation in affecting the viability of institutions. It was beyond the scope of this paper to revisit the effect that government regulation and subsidies have had on financial structure See, for example, Kane (1981) or Eisenbeis (1985) It remains the case, however, that the literature on the theory of the banking firm does not rely on the existence of government regulation or subsidies to explain the existence of finanical institutions Nevertheless, the point is well taken.

[8] See, for example, Fama (1980), Black (1970), Hall (1982), and Balternsperger and Dermine (1987).

include standard options contracts to withdraw deposits upon demand (liquidity services) as well as other options and contingent claim contracts (such as letters of credit and standby letters of credit), and exchanging fixed for variable or variable for fixed claims (including interest rate swaps). These insurance services rest on indivisibilities as well as economies in credit evaluation and access to costly information.

4) Monitoring services. Financial intermediaries also assess credit risk and monitor the payment performance on assets in the portfolio. Financial intermediaries can address the problems of devising and pricing financial contracts when there is both public and private (asymmetric) information and monitoring is costly. Borrowers may deal with intermediaries and reveal private information that the intermediary will not divulge to the public and, in turn, will monitor performance for the intermediary's investors and creditors.[9]

If institutions just provided portfolio diversification and payments services, there would be no need to regulate banks or financial intermediaries.[10] Banks would not be special; they would essentially function as mutual funds whose assets would be marked to market on a continual basis. Shareholders would receive the market rate of return adjusted for risk and a management fee.[11] It is the insurance functions, and in particular the liquidity services of redeeming claims at par upon demand or very short notice, that make banks special when compared with other financial intermediaries and raise the question of whether there is a public interest in regulating banking organizations. Recent developments in financial markets, however, raise serious questions about how "special" banks are in providing insurance, liquidity, and transactions services anymore. These are discussed in the next section.

9 The role of intermediaries when there is costly monitoring and private information has been an active area of recent research in the finance literature. See Jacklin (1984), Diamond (1984, 1986)

10 See Fama (1980) and Black (1970).

11 See Baltensperger and Dermine (1987).

Recent developments in financial markets

The pace of change since the early 1980s has, if anything, accelerated. Two recent developments have been particularly noteworthy and represent important breakdowns in market imperfections that have historically provided the rationale for the existence of financial intermediaries.[12] [13] These are (1) the explosive growth of asset securitization and contingent claims and (2) the internationalization of financial markets.

Developments in the application of options and asset pricing theory, securitization, and the growth of contingent claims and guarantees have led to an unbundling of the services traditionally provided by depository intermediaries into their component parts. These elementary services can be provided economically and often at lower cost. For example, stripping coupons from bonds segments the interest stream from the principal, creating a zero coupon bond, and changes the interest rate and price risk characteristics of the security. The spread of pass-through securities has resulted in a segmentation of the origination, credit evaluation, and pricing of credit risk from the credit intermediation function. Standby letters of credit have become pure insurance contracts enabling banks to continue their credit risk and assessment functions without having to fund the transaction. Interest rate futures contracts segment the interest rate risk component from the other components of a financial transaction, allowing institutions and individuals to hedge or to speculate on interest rate movements. The growth of foreign exchange options and the introduction of consumer exchange warrants (CEW's) enable corporations and individuals to take an interest in foreign exchange movements without having to take positions in the currencies themselves.[14] Finally, because of the growth in asset securitization, heretofore nontraded or illiquid assets can be valued, and most importantly, whole new securities can be created that divide up the long-term immedi-

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12 For discussions of Imperfect markets models of banking, see Pringle (1972), Klein (1971), and the review paper of Santomero (1984)

13 For discussions of the process and history of financial change and innovatton, see Eisenbeis (1986) and Kane (1981).

14 See Forde (1987).

ate-term, and short-term credit and intermediation risks associated with longer-term securities. In short, the kinds of instruments being traded in financial markets have changed radically. These new instruments perform functions essentially similar to those provided by traditional intermediaries. Banks and thrifts, for example, traditionally have provided both maturity intermediation and denomination intermediation services. These new asset securitization techniques provide a way, through the creation of derivative securities, to perform these same functions. Short, intermediate, and long securities can be issued against a pool of long-term assets, such as mortgages, that can be tailored to meet the investment and maturity preferences of individual and institutional investors. Instead of having to hold the liabilities of a financial intermediary to obtain desire maturities and diversification benefits, derivative securities can be held.

One important development following from the spread of securitization is the potential decline in demand for'the services provided by traditional depository financial intermediaries. High-quality credits will be increasingly attractive to creators of derivative securities and the lower rates will compete away these high-quality credits, which had traditionally been the major sources of business for banks. Moreover, the design, underwriting, and distribution of securitized assets is not an activity that banks have traditionally engaged in because of Glass-Steagall restrictions on securities activities. Faced with an erosion of their traditional borrowers, banks have sought to engage in securities activities through their bank holding company subsidiaries or abroad.[15]

This move by borrowers and lenders from the indirect to direct credit markets, driven by cost savings estimated to be on the order of 140 basis points, has already happened in the corporate credit market.[16] Large, high-quality corporate borrowers now rely significantly on access to the U.S. domestic and Eurocommercial paper market for short-term funds. Commercial paper has grown from $200 million in 1983 to $320 million in 1986. Longer-term funds are

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15 See Kaufman (1985, 1987) or Eisenbeis (1987) for descriptions of the securities activities of banking organizations.

16 Rose (1987).

obtained in the long-term debt and Eurobond markets. Eurobond issues, for example, have grown 33 percent since 1980.[17]

High-quality middle-market corporate customers are also benefiting from the growth of direct credit market alternatives. Junk bond financing doubled in 1986 and the use of credit enhancements in the form of standby letters of credit and other types of guarantees have increased the acceptability of less known borrowers to investors.

As a result of these developments, there has been a shift in the institutions who are participating in these markets away from traditional intermediaries towards securities firms and investment bankers skilled in the creation, design, and distribution of these new derivative securities. Investment bankers, in particular, are increasingly providing not only advice and aid in the structuring and distribution of financial instruments, but they also are providing a significant credit function in connection with their underwriting activities. In addition, mutual funds and pension funds have become attractive to individuals that would otherwise hold liabilities of financial intermediaries, and as part of the diversification services they provide, these institutions have become important sources of funds to business.[18] Today, other financial service firms are almost as important as banks and thrifts holding about 45 percent of the total private financial assets held by financial service firms.[19]

The end results of this process of financial change are a further breakdown of some of the traditional market imperfections that have segmented financial markets and given financial intermediaries a competitive advantage. The increased substitutability among financial assets reduces the need for corporations and individuals to hold bank liabilities for precautionary and store-of-value purposes. The reduction in market imperfections and the increased incentives and willingness of individuals and corporations to hold financial assets other than bank liabilities furthers the trend toward disintermediation as

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17 Data source, Rose (1987).

18 Rose (1987) reports that of the $918 billion of bank time and savings deposits and mutual fund shares, mutual funds held 15 percent. By 1986, mutual funds were estimated to hold 36 percent of the total of bank time and savings deposits and mutual fund shares, which hade increased to $1.93 billion.

19 Data date 1983, source *Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services,* 1984.

borrowing and lending activities move increasingly from the indirect to direct credit markets.

The second development has been the internationalization and integration of financial markets as both borrowers and lenders increasingly are able to obtain funding or engage in transactions across borders. U.S. financial institutions now have significant presence abroad. This includes not only banking offices but also merchant banking, dealing and underwriting debt and equities, underwriting and brokering life insurance, management consulting, and brokering real estate. U.S. banks were lead managers in from 12 to 15 percent of the Eurobond underwritings in 1985.[20] U.S. firms also have significant nondomestic options for raising funds. These include not only the ability to borrow from the U.S. office of foreign banks or from foreign banks abroad, in London, Tokyo, Germany, or Switzerland. Similarly, U.S. and non-U.S. firms are bypassing financial intermediaries and accessing credit and other financial service markets directly.[21] U.S. companies are issuing both stock and bonds in foreign markets, often at costs below those in domestic markets.[22] The result is increased integration of domestic and foreign markets from both the borrower and lender sides of the market. The prices and availability of funds in U.S. markets are no longer insulated from those prevailing in the rest of the world as both borrowers and lenders arbitrage spreads and terms as the opportunities arise. This integration also means that regulatory policies designed to restrict the activities of either borrowers or lenders in domestic markets can be easily avoided by shifting financial activities to nondomestic markets. Moreover, as the costs (both information and transactions) of these avoidance activities decline, the more the international activities of U.S. corporations and financial institutions expand.

A number of forces have contributed to this internationalization of U.S. markets. Freer trade flows have opened up opportunities for companies generally. The reduction in regulatory barriers has opened

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20 See Board Staff (1986) for this and other measures of the foreign activities of US banking organizations.

21 Kodak Corporation, for example, even has their own foreign exchange trading operation with a trading desk in Rochester, New York

22 Even major regional U.S. banks are turning to foreign markets to raise equity. NCNB Corporation's stock is now traded in Tokyo.

up foreign markets to international banking organizations.[23] Foreign banks, for example, have expanded significantly in the United States and have widened the scale of their dealings with U.S. domestic customers.[24] As of 1986, there were more than 250 foreign banking organizations that had a presence in U.S. financial markets, and these firms had aggregate resources of $500 billion.[25] These institutions know many more U.S. borrowers than previously, and by virtue of their parent companies' positions in their home country markets, they are able to assist in flotation of the securities of U.S. firms abroad. Moreover, many are able to offer a wider array of securities and other financial services precluded to U.S. banks by regulation. These advantages are probably significant in explaining why foreign banks now account for about 20 percent of the commercial and industrial loans to companies with U.S. addresses.[26] Similarly, U.S. banking organizations help foreign companies issue securities in U.S. and foreign markets. This latter activity has been facilitated by the recent opening of foreign securities markets to U.S. banking organizations. The 1986 Financial Services Bill, so called Big Bang in the United Kingdom, for example, opened the London market more to U.S. banking organizations and provided for an integration of securities underwriting, distribution, and investment within banking conglomerate~.[27] As already suggested, the availability, access, and free flow of information, has made it easier for lenders to assess the risks of dealing with offshore borrowers.

Internationalization has made it increasingly difficult for individual countries to maintain regulatory structures or regulations different from those in the rest of the world. There are two reasons for this. The first is the ease with which financial institutions, through financial innovation, can avoid the regulatory restrictions of individual

23 See Kane (1986) for a description of how regulatory barriers to raise equity.

24 Even in the late 1970s, foreign banks were important sources of funds to corporations In some months, foreign banks accounted for over 60 percent of the credit supplied to major corporations in New York.

25 Comgan (1987).

26 Comgan (1987).

27 Another U.K. bill will permit thrift institutions to compete more freely with banks, including the making of personal and corporate loans, the offering of Insurance, and equity participations.

countries.[28] The second is that regulatory avoidance is encouraged by regulatory bodies in individual countries that seek, by providing accommodating regulatory climates, to attract and expand the institutions doing business in their country. Kane (1986) has described the nature of this international structural arbitrage, and the inescapable conclusion is that it has now become extremely difficult?if not impossible, to pursue domestic regulatory policies without the cooperation of foreign regulators. For example, the U.S. regulatory agencies recently published for comment capital adequacy standards to be applicable to banks in the United Kingdom and the United States. Peter Cooke, Associate Director of the Bank of England, recently indicated that he had begun work to bring the Japanese into the arrangement as well to ensure competitive equality among the major competitors in financial markets.[29]

These developments are having far reaching consequences for the competitive viability of certain institutions and are also raising concerns about potential risks in financial markets. For example, increased securitization of assets has given an advantage to those institutions adept at designing contracts and distributing securities and derivative instruments. Traditional lenders have seen the erosion of their markets and disappearance of many of their low-risk customers as technological and market changes eliminate or significantly reduce market imperfections that provided economic opportunities for financial intermediaries. In this environment, it seems increasingly clear that banks are no longer unique and that the role they play in the financial system has changed significantly.

The uniqueness of banks

Similar to what finance theory suggests, the regulation of banking and the rationale for restricting banking activity hinges on the supposedly special role that banks play in the financial system.[30] A well-

28 See, for example, Kane (1981) or Eisenbeis (1986).

29 Cooke (1987).

30 For discussions of the history and forms of the regulation of banking, see Huertas (1983) and Benston (1983)

functioning financial system enhances the efficiency of producing goods and services, thereby expanding the wealth and income of society. Financial market instability reduces income and can result in recessions and economic depressions. The supposed externalities associated with cumulative bank failures have provided the rationale for public intervention.[31] The traditional arguments that banks are special rest on (1) the role that banks play as sources of liquidity, (2) the importance of bank liabilities as money, and **(3)** the inherent liquidity problem banks face because certain bank liabilities are redeemable at par on very short notice or upon demand whereas their liabilities are not.[32] [33] These roles are briefly evaluated below.

Bank liabilities as money

In the early history of this country, individual banks issued their own bank notes to the public promising to redeem the notes at par for specie. At their peak, the notes of over 6,000 banks were in circulation. When given in exchange for goods or services, not all notes were equally valuable to the public, and for this reason, it was not uncommon for notes issued by out-of-area banks to trade at discounts, despite the fact that they, were supposedly redeemable at par for specie.[34] These discounts reflected several factors, including transportation costs for both notes and specie, transaction costs, lack of information on the issuing bank, and uncertainties about the creditworthiness of the issuing bank.

While lack of par clearance in no way affected the ability of state bank notes to function as money, it did result in many inefficiencies. Exchange rates among notes had to be established, prices of goods had to be adjusted to reflect these rates, and real resources

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31 For a summary of the arguments, see Aharony and Swary (1983).

32 Comgan (1986) indicates that a large modern economy requires the existence of an asset that is both highly liquid and readily transferable at par. This asset has been provided by currency and bank demand deposits.

33 See Benston and Kaufman (1987)

34 Under the Suffolk system that was in place in the Boston area during the 1800s, state bank notes did trade at par. This par clearance was the result of competitive market forces and fundamental economic incentives.

had to be used to arbitrage exchange rates in the process of returning notes to the issuing bank when they were presented for payment.

Since note issues typically were not backed 100 percent by gold or silver reserves, periodic liquidity problems arose when note holders became concerned that a bank might not be able to honor its redemption commitment. Runs on individual banks and the system sometimes occurred, and these resulted, albeit infrequently, in cumulative contractions in the money supply. Loss of a dollar of specie meant loss of the ability to support several dollars of notes outstanding.[35] [36] Suspension of convertibility was a common way for early banks to deal with temporary liquidity problems.[37] This prevented a cumulative decline in the volume of an individual bank's notes outstanding and prevented failure but often resulted in a substantial loss of purchasing power as the discounts on notes of banks that-had suspended convertibility often increased substantially. This decline in purchasing power shifted the cost of nonconvertibility, at least temporarily, to the creditors (depositors) of the bank, giving all liability holders an important incentive to worry about bank solvency. Indeed, Kaufman (1986) notes that bank capital ratios during this period were substantially higher than they were subsequent to introduction of federal deposit insurance.[38]

For these early banks, avoidance of runs meant maintenance of public confidence that the institution could convert notes into specie in sufficient amounts to avoid the need to suspend convertibility. Indeed, the first forms of public regulation to deal with the problems of suspension of convertibility were the imposition of reserve requirements specifying permissible ratios of notes to specie. Maintenance of public confidence was assured by engaging in minimal maturity intermediation, maintaining sufficient specie reserves, and having adequate capital and liquidity. Most commercial banks tended to make

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35 For a discussion of bank runs, see Kaufman (1986) and Bryant (1980)

36 Kaufman (1986) maintains that these runs were not nearly as costly as sometimes has been alleged.

37 Clearing houses and other banks in the region also provided temporary credit to institutions experiencing liquidity problems. See Kaufman (1986) and Kaufman and Benston (1987).

38 Peltzman (1970) had long argued that banks tended to substitute deposit insurance for capital

short-term loans, which were predictably and periodically repaid in either specie or notes.[39]

The creation of the national banking system in 1864 and the imposition of a tax of 10 percent on the issuance of notes by individual state-chartered banks in 1865 finally drove state bank notes out of existence.[40] State banks, however, remained viable and prospered because demand deposits, and not currency, had become the principal bank financial liability that was traded and used in making transactions. Just as with state bank notes, not all checks cleared at par, yet these liabilities were accepted and were readily used as a medium of exchange. It was not until the Federal Reserve Act of 1913 that all member banks were required to clear checks at par.

Thus, contrary to the assertions of some authors, par clearance was never a necessity as far as the public was concerned for bank liabilities (either bank notes or bank deposits) to serve as money.[41] [42] Rather, the key attributes are related to value determination and acceptability, attributes that are becoming increasingly important today for the liabilities of other financial intermediaires.

Liquidity considerations, safety and soundness, and bank runs

With the advent of demand deposits as the principal component

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39 These early banks, did make longer term loans and did not, however, cling to an extreme form of the Real Bills Doctrine in conditioning their lending behavior, as some authors have suggested. See Klebener (1974)

40 Creation of the national banking system was motivated in large measure, as were many previous financial reforms, by the need to finance a war The issuance of a national currency backed by federal debt was an indirect way of financing the Civil War through inflation

41 Corrigan mistakenly argues that to function as money, bank liabilities must be redeemable at par U.S. financial history is filled with examples of bank liabilities that functioned as money but were not redeemable at par. During the early 1800s, state bank notes circulated as money but were not always redeemable or convertible at par. In fact, there was a whole industry that consisted of publishing information on the notes of banks and on making markets in the notes of individual banks, some of which would be converted at par and others at discounts. To be sure, par conversion or acceptability is more efficient but is certainly not crucial for bank liabilities to serve as money. Moreover, inefficiencies decline as transactions and information cost declines

42 To be sure, there were periods, such as the experience in New England with the Suffolk system, when notes cleared at par. See Robertson (1964) or Redlich (1966). There is also no denying that par clearance reduces the problems of determining exchange rates, eliminates circuitous routing, and reduces the use of private real resources in operating the payments system.

in the money supply, liquidity concerns changed from focus on specie convertibility to the ability to meet demands for withdrawals of currency or payments of checks to other banks. This was accomplished by maintaining sufficient volumes of reserve balances, demand notes, government securities, or other marketable assets in a bank's portfolio.

In the case of national banks before passage of the Federal Reserve Act, legal reserves included not only cash in vault but also deposits at reserve city and central reserve city banks. Permitting balances held at other banks to count as legal reserves resulted in a pyramiding of reserve assets' within the banking system. It constituted a major structural flaw in the national banking system, and, as later history demonstrated, was a major source of financial instability. A run or unanticipated demand for funds by a rural national bank created a call on interbank reserve deposits. If the reserve city bank did not have access to sufficient funds to meet the withdrawal of interbank deposits, then loans had to be called or assets sold. When assets were liquidated, the result was a cumulative decline in bank loans and deposits outstanding in the system.[43] Thus, with the pyramiding of reserves, it was easier for a run on an individual bank to have systemic systemwide effects.[44]

An important attribute of the early runs is that they were usually flights to currency.[45] Depositors lost confidence in the ability of the institution to make good on its commitments to redeem deposits so they attempted to convert their deposits into currency before the bank

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43 After creation of the Federal Reserve System, imposition of member bank reserve requirements were employed as a monetary policy instrument. Numerous research has argued that reserve requirements are not necessary for effective implementation of monetary policy. See, for example, Fama (1983), Wallace (1981, 1983), Bryant and Wallace (1984), Kareken (1984), and Baltensperger and Dermine (1987). The argument is that as long as banks voluntarily hold reserves in the form of currency or base money for precautionary and liquidity purposes, due to transaction wsts and because bank deposits are not risk free, and as long as the government has a monopoly in the creation of currency and base money, then the monetary authority can effectively Implement monetary policy. The import of this work and the lack of evidence that deregulation has had substantial macroeconomic effects, is that monetary control considerations should not play an important role in affecting the strucutre of the regulation of the financial system. See Baltensperger (1982), Santomero and Siegel (1985), and Baltensperger and Dermine (1987)

44 According to Kaufman (1986), however, the economic consequences of these runs have been overestimated for a was common for private arrangements through individual banks and clearing houses to provide emergency liquidity to economically solvent institutions in need of temporary help.

45 See Kaufman (1986).

became insolvent. Such runs withdrew base money from the system and contributed to a cumulative collapse of the money supply as banks loans were called in or assets sold, often at panic or "fire sale prices."

Creation of the Federal Reserve System dealt with the fundamental instability of the fractional reserve system in two principal ways. The 1913 act eliminated the use of interbank deposits as legal reserves and substituted deposits held at the Federal Reserve. Additionally, the Federal Reserve was to serve as a temporary source of liquidity by providing emergency credit through the discounting of eligible collateral. In this way, institutions could avoid technical insolvency that resulted from having to sell otherwise good assets in markets at distressed (fire sale) prices due to a temporary glut on the market and the high costs of quickly seeking out buyers. Unfortunately, during the Depression, the Federal Reserve failed to provide the needed liquidity, and it is estimated that the money supply collapsed by as much as one third.[46]

The failure of the Federal Reserve to provide adequate reserves during the Depression contributed to the institution of federal deposit insurance.[47] Deposit insurance effectively made bank failures independent events by breaking the link between the value of a bank's assets and the ability of insured depositors to obtain their funds when a bank's net worth became negative. Insured depositors had no reason to be concerned about their ability to receive their deposits regardless of the value of the bank's assets or the value of the assets of any other bank in the financial system. Implementation of the failure resolution provisions of the Federal Deposit Insurance Act has resulted in de *facto* 100 percent insurance for depositors for most of the period since 1933. Since most bank failures were resolved by a purchase and assumption transactions, the acquiring bank assumed both the insured and uninsured deposits of the failed bank, which reduced the potential costs of failure to uninsured creditors significantly. It has only been recently that there have been limited attempts to avoid de *facto* 100 percent insurance through the use of limited payouts, etc.[48]

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46 See Friedman and Schwartz (1963).

47 Friedman and Schwartz (1963) regard federal deposit insurance the single most important reform of the 1930s

48 See Kane (1986) for a discussion.

It is important to digress for a moment to discuss more precisely what is meant by "confidence" as it pertains to bank runs because the concept has sometimes been abused. Confidence is not a subjective or ephemeral concept. It does not relate to the management or to intangible attributes of the firm. Rather the role of confidence is most easily understood if related to depositors' assessment of the market value of the institution's assets relative to its liabilities. As long as the market value of the institution's net worth (including the value of any conjectural guarantees) is positive, then there is no need for a depositor to be concerned about being able to redeem his deposits for currency. With negative net worth, it makes perfect sense for uninsured creditors to attempt to obtain their funds, because some creditors in line will not be paid. Thus, the way for an institution to establish (or to reaffirm) confidence is to reveal to existing as well as potential depositors and other uninsured creditors the true quality (market value) of its assets. Convincing the market that it had a positive market value net worth is precisely what Continental Illinois and most of the state-sponsored-insured S&L's in Ohio were, in the end, unable to do precisely because they were insolvent, but what Manufactures Hanover was able to do. It is also important to note that the runs in the Continental Illinois situation and in the Ohio S&L situation were not runs on the financial system or flights to currency. Funds withdrawn were redeposited at other institutions that did have positive market value net worth. In the case of the S&L crisis in Ohio, funds were withdrawn from institutions insured by the state-sponsored fund and deposited in federally insured banks and thrifts. These withdrawals took place because depositors perceived the state-sponsored fund to be underfunded and the state demonstrated that it was unwilling to provide adequate funding after the crisis began. The public also demonstrated its ability to distinguish between solvent and insolvent institutions insured by the state-sponsored fund. Not all experienced runs, and there is no evidence of runs on federally insured institutions. In fact, one noninsured institution remained open throughout the crisis. It is this link between the market value of a depository institution's net worth and public confidence that has led some reformers to argue strenuously for market value reporting for depository institutions.[49]

49 See Benston, Eisenbeis, Horvitz, Kane, and Kaufman (1986).

Runs to currency are less likely today than in the past.[50] Currency runs are impractical for large dollar depositors. Withdrawing tens or hundreds of millions of dollars in cash from a large U.S. bank would be physically impossible. The volumes of currency would not be readily available, even from the Federal Reserve, and transportation and storage would be difficult and costly. Most small dollar depositors' accounts are insured, so there is no need to engage in a currency run. In fact, despite the fears of the Federal Reserve that failure of Continental Lllinois would cause creditors, especially foreign creditors to lose confidence in the entire system or significant components thereof, this is a very unlikely event.[51] [52] First, federal deposit insurance, as it has been implemented, has broken the link among institutions, making failures independent events.[53] Second, it is less costly and much easier to demonstrate solvency to the public than it was during the Depression. We now have public disclosure requirements, and income and balance sheet information on individual institutions are now readily and publicly available.[54] Rating firms now monitor continuously and rate the CD's and debt of many banks and thrifts. In addition, with the rise of passthrough securities and securitization in general, it is becoming easier to price heretofore hard to value assets on bank balance sheets. Finally, with the advent of modern communications, dissemination of the relevant information

50 Kaufman (1986) provides a useful discussion of the historical evidence pertaining to bank runs

51 It is remarkable that there has not been a major run on S&L's The vast majority of them are insolvent, as is the FSLIC. The main element preventing such a run is public confidence that the U S. government will make good on its commitment to insure the deposits in failed institutions The Important feature of the present situation in the S&L industry is the importance of considering the value of the guarantees when determining solvency (in this case, solvency of the FSLIC)

52 Meltzer (1986) argues that the methods the Federal Reserve used in the Continental Illinois case actually increased the risk of loss of public confidence The failure of the Federal Reserve to provide emergency credit itself and instead putting together a group of U.S banks to provide credit to Continental Illinois signaled to the market concerns by the Federal Reserve about the quality of Continental Illinois' assets.

53 For arguments for reducing Insurance coverage, see Kane (1986) or Benston, Eisenbeis, Horvitz, Kane, and Kaufman (1986).

54 Before the early 1970s, only an abbreviated balance sheet was required to be disclosed and non income and expense reports were public information

is easier and less costly. A welcome and needed addition would be the ready availability of market value accounting data.

Deposit insurance was put in place in part as a response to the failure of the Federal Reserve to liquify sufficient assets of banks during the Depression. It was specifically structured to protect the wealth of small depositors by protecting them from loss of their deposits when a bank failed. Similar protection was afforded the wealth holdings of small depositors in S&L's. The problems of the present structure of the federal deposit insurance system and the risk-inducing elements associated with the flat-rate premium structure as net worth goes to zero has been well described elsewhere and will not be discussed here.[55] However, it is important to reconsider the structure and function of deposit insurance in a world where numerous financial liabilities other than those issued by banks and thrifts can serve the same money function as bank liabilities, where most abodes of purchasing power are held in the form of liquid financial assets other than demand deposits, and where insured transactions accounts may only have nonzero balances in the process of liquidating a financial asset to make a transaction.

These issues arise because the payments system and medium of exchange have changed significantly since the Federal Reserve was created and deposit insurance put in place. Protecting the payments system no longer means protecting the money supply or protecting competitors because of fundamental changes that have occurred in the way payments are made and in what constitutes the money supply. Each of these will be considered in turn.

Reductions in market imperfections and changes in money and the way payments are made

As has already been suggested, financial innovations have changed significantly both the instruments and the way payments are typically made. Moreover, the institutions whose liabilities now are important elements in the payments system have expanded significantly, and, hence, the liabilities that serve the function of money have

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55 See Kane (1986) or Benston, Eisenbeis, Horvitz, Kane, and Kaufman (1986).

increased.[56] Checks are rountinely written on savings (NOW) accounts at both banks and S&L's, S&L's and mutual savings banks offer checking accounts, and credit unions offer share drafts. Checks are also written on cash management accounts at brokerage houses and on money market mutual funds, accounts that are marked to market each day. Debit cards are the technological equivalent of a check. Through the use of computer technology, the debit card reduces float for the issuing institution, which now must be paid for if the Federal Reserve paper check clearing services are used. These cards, when used in an electronic payments system, authorize the withdrawal of specified amounts and payment to a second party by electronically drawing down one account and debiting another, at the same or different institutions. Finally automatic transfers and automated clearing house (ACH) transactions are being used for predictable and large volume payments, such as social security payments, dividend payments, etc.

Less attention has been given to credit card transactions that now play an important role in the payments system as far as individuals are concerned. Credit card transactions are orders to pay that are made at less than par by an intermediary which then collects from the drawer at a later time. Merchants, at whose store transactions are initiated, agree to accept a discount, historically averaging about 5 percent, in exchange for clearing and settlement (the price of the transaction is presumably imbedded in the cost of the good.) The merchant receives immediately available funds and credit is extended by the intermediary to the drawer until settlement is made. Rather than settling each transaction (as is done with a check) the settlement between the drawer and the intermediary is done usually once a month. Credit card transactions function as a broadbased payments medium that needs little or no reliance upon traditional transactions balances. The drawer pays for the credit extension by writing a check on a transaction account or liquidation of some other financial asset. The merchant receives a credit from the bank in the form of an increase in a transaction account, which is presumably converted im-

56 There is, of course, voluminous literature on the demand for money and the effects of financial innovation on monetary control, but coverage here is beyond the scope of this paper. For references, see Tobin (1983), Lindsey (1977), Kareken (1984), and Santomero and Siegel (1985).

mediately into an interest earning financial asset. Note too, that while there is nonpar clearance, only one party to the transaction need be aware of it.[57] Similar to credit card transactions are travel and entertainment card transactions, where payment of the entire outstanding balance is required each payment period. This use of credit substitute transactions mediums enable individuals to economize on traditional transactions balances and, in fact, can finance transactions through instantly approved credit if sufficient funds are not on hand.[58] The distinctions between credit transactions and regular demand deposit transactions have become blurred because of the use of automated credit evaluation systems and through the use of lines of credit that serve to reduce the costs of credit evaluation. This reduces the costs to consumers of making credit purchases versus check or cash purchases.

More important than these new close substitutes for demand deposit payments are methods that evolved to reduce the need for large dollar balance holders to hold funds in transaction accounts. A host of cash management devices, such as the use of zero balance accounts, deposit scanning, and lockbox arrangements, are employed to collect funds that would otherwise be held in the form of idle balances and channel them into instruments yielding a positive rate of return. When payments need to be made, these interest earning assets are liquidated, the proceeds temporarily deposited in a transaction account, and immediately disbursed over Fedwire or CHIPS. Upon receipt, funds are immediately converted into an interest bearing asset, even if it is only to earn interest overnight. Today, for most large dollar depositors and increasingly for small depositors as well, computers and the ease and reduced costs of converting interest bearing financial assets into demand deposits means that the traditional function of money balances as a source of liquidity is becoming less and less unique or important. A demand deposit is evolving into an account that at any particular instant in time has a zero balance. The account only has balances, as funds are swept into and out of the account

57 It used to be against the law for merchants to charge differential prices for cash versus credit transactions. That prohibition, however, has expired.

58 These cards with their option to pay at the end of the month or to finance the transaction through an automatic extension of credit illustrate how fine the line is now between transaction accounts and credit

in the process of clearing and settlement for the brief time that it takes to make a transaction.

With the continued evolution of asset securitization and the development of easily divisible securities (i.e., mutual funds shares) and increasing use of computer technology, it is likely that more and more transactions will be taking place without even the temporary use of a transaction account. Once there is low cost convertibility of assets into easily valued securities or shares in mutual funds it is a small step to bypass traditional transaction accounts when assets are exchanged. Electronic financial barter and exchange of ownership of almost any financial are as easy, and involve fewer steps, than' first converting the assets into funds in a transaction account and then exchanging ownership of a demand deposit. All that is needed is a message and switching system and a means to ensure that orders are carried out (settled).

In fact, the key attributes and policy issues associated with an electronic barter system are already in place with CHIPS and Fedwire and the methods used for large dollar transactions. It is the changes in the way that large dollar payments are made that has focused attention on payments system issues as part of regulatory reform proposals and these are discussed in the next section.[59]

Payments system changes

When the Federal Reserve System was created and federal deposit insurance was put in place, most payments were made by checks drawn on demand deposits with the remainder made in currency. Demand deposits were the dominant bank liability and the source of funds to support lending activity. There were not close substitutes for bank liabilities or the functions they performed; nor were financial markets sufficiently deep that there were ready markets for the assets on bank balance sheets. Within that structure, protecting the payments system meant preventing the cumulative collapse of they money supply. And since the money supply consisted of currency

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59 See Corrigan (1986).

and demand deposits, this meant that prevention of bank failures would prevent destruction of demand deposits.

Today, the payments system is larger, has many more components (both private and public), and is subject to different risks than in the past. The check/demand deposit system, which accounts for the bulk of individual payments except for currency, and the one that the present regulatory structure was primarily designed to protect, is in reality small in terms of the dollar volume of payments made today. While about 40 billion checks, amounting to about $36 trillion, are written on average each year, checks account for only about 12 percent of the nation's payments in terms of value today.[60] The rest are made in the form of computerized transfers of reserve balances on the Federal Reserve's Fedwire system and the privately owned CHIPS (Clearing House Interbank Payments System) system, and in the form of ACH transactions. Payments on the former two systems account for about 85 percent of the transactions made today.[61] Closely related to these systems are the automated transfers of book-entry Treasury securities that also take place on Fedwire and which involve substantial volumes of transactions.[62]

Transfers on the Fedwire system may be initiated by a bank on behalf of customers, but actually involve'bank-to-bank transfers of balances held at Federal Reserve banks. These transactions are always very large, averaging $2.5 million per transaction. Average daily volume amounts to about 200,000 transactions totaling $500 billion.[63] About 99 percent of these transactions are computerized, originating on terminals or through computers at over 7,500 depository institutions directly connected to Federal Reserve computers.

Parallel to Fedwire is CHIPS. CHIPS is owned by the New York Clearing House and connects some 140 institutions, including 11 of the 12 members of the New York Clearing House, other U.S. commercial banks, about 80 branches and agencies of foreign banks, and numerous Edge Act companies.[64] CHIPS handles both domestic and

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60 See Huertas (1986).

61 See Huertas (1987).

62 See Huertas (1987).

63 See Mengle, Humphrey and Summers (1987).

64 Although it is not a U S bank, American Express is a bank abroad and participates in CHIPS.

foreign payments and is the major clearing system for dollar-denominated international payments. Over 90 percent of the dollar payments between countries throughout the world take place on CHIPS. The volume of transactions on CHIPS is nearly as large as those on Fedwire. Average daily volume is $425 billion for about 114,000 transactions. The average transaction size of more than $3.75 million is even larger than on Fedwire. Similar to Fedwire, all CHIPS transfers are on-line electronic payments initiated by settling banks and sent directly to the CHIPS computer.

ACH transactions are also electronic transactions but, unlike CHIPS and Fedwire, are batch transactions with the payment information distributed prior to settlement. By and large, ACH transactions are small dollar transactions, such as social security benefits, dividend payments, etc., and volume remains quite small compared with CHIPS and Fedwire. During 1985, there were 283 million commercial ACH transactions totaling $1.8 trillion (less than four days' transactions on Fedwire).[65]

The fourth giant element in the current payments system is the book-entry system for transferring government securities that also take place over Fedwire. The electronic transfer of ownership of paperless book-entry Treasury obligations are initiated by the seller of securities through the seller's bank. Securities are transferred from the seller's bank's account to the account of the buyer's bank, and payment involves a debit of the buyer's bank reserve account and a credit to the seller's bank's reserve account. About 300,000 such transfer per day took place during 1986, amounting to a daily average volume of $260 billion. The average transaction size was $8.7 million.

In the case of all'of these payments systems; they consist of two components. The first is a notification and accounting element in which messages of orders to debit and credit certain accounts are routed electronically to the appropriate institutions. The second is the actual transfer of funds among institutions. For reasons of economy, funds are not transferred with each transaction. Rather, the electronic system keeps track of the net position each institution has with other participants, and only the net differences are "settled"

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65 It was not until 1986 that private institutions through ACH's exceeded U S government transactions on the system

at the end of the day by transferring ownership of reserve balances held at the Federal Reserve.

Payments system risks

The structure of these payments systems determine the risks they are subject to, who bears that risk, and how vulnerable the systems are to certain kinds of shocks. For example, in the case of Fedwire, once a payment is initiated and in the system, the receiving bank is guaranteed by the Federal Reserve that it will be delivered funds. That is, failure of the sending institution will not affect the receiving bank. Another convention of the system is that transactions result in immediately available funds for the receiving bank, but settlement by the sending bank with the Federal Reserve is at the end of the business day on a net basis, rather than on a transaction-by-transa'ction basis. In effect, the Eederal Reserve interposes itself between the sending and receiving bank to guarantee the transaction. The Federal Reserve absorbs the credit risk (for a zero return) during the day that a sending institution will not be able to settle its net debit position at the end of the day.

Because of its structure, risks on Fedwire are mainly credit risks borne by the Federal Reserve and the participating banks.[66] These credit risks arise because of the way the settlement and clearing of transactions are structured. For the sending institution, there is the risk that the customer (which may be a corporate customer or a financial institution with an account at a clearing bank) requesting a payment to be made over Fedwire may not be able to cover the transaction. This risk is presently controlled through the establishment of customer overdraft limits that the clearing banks monitor on a real-time basis. The Federal Reserve has significant risk exposure due to the convention of providing immediately available funds to the receiving bank but not requiring settlement by the sending institution until the end of the business day. This policy encourages sending banks to make payments early, creating large daylight overdrafts to obtain free credit from the Federal Reserve and then to borrow

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66 There is always the operations risks that would be associated with technical problems with the system.

Federal Funds or otherwise cover its net debit position just before the close of business.[67] Daylight overdrafts grew significantly during the 1980s, and in many cases amounted to several times the invested capital of clearing banks. Daylight overdrafts averaged about $40 billion per day on the system.[68] [69]

, For a long while, the Federal Reserve did little to control its exposure to daylight overdrafts. Now, however, two methods of risk control are used: ex post monitoring and the establishment of bilateral ceilings, or caps, for set maximum overdraft exposure for institutions. The Federal Reserve established its caps in March 1986, and unlike the normal situation where a lender does the credit evaluation and establishes limits for lines of credit, in the case of sender net debit caps, the Federal Reserve permitted the caps, established as multiples of the institution's capital, to be based on a yearly self-evaluation by the borrowing institution's board of directors.[70] Factors to be considered in establishing the caps are the institution's ability to control, monitor, and evaluate its daylight overdraft exposure, and an evaluation of its creditworthiness. As the result of continued concerns about the volume of daylight overdrafts, the Federal Reserve reduced the caps by 25 percent in July 1987.

As of June 1986, only three of the 12 Federal Reserve banks had automated capabilities to monitor exposure to daylight overdrafts on a real-time basis, and only financially distressed institutions are monitored on a real-time basis.[71] The alternative way for the Federal Reserve to control its risk would be not to allow any overdrafts in the system at all. This would require continuous monitoring, which has not yet been put fully into place. The arguments against not allowing overdrafts pertain to the supposed disruption to confidence that individual institutions would experience when payment orders were

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67 The speed with which transactions are entered and processed have become increasingly important. Customers have recently complained about delays on Fedwire

68 See Ireland (1986).

69 More recent data reported by Kantrow (1987) indicate that "More than 1,000 banks routinely run a total of $130 billion a day in funds transfer overdrafts . . ."

70 A cynic might argue that this is similar to putting the fox in charge of the hen house.

71 It was estimated that all 12 banks would have real-time monitoring capabilities by mid-1987. See Ireland (1986)

rejected.[72] This concern, however, would seem to be of little merit. First of all, institutions faced with the prospects of having payments rejected would have incentives to monitor and control their own risk exposure rather than seeking to take free credit from the system. This would introduce a desirable element of market discipline into the system. Second, there would be little instability introduced since there is no systemic risk on the system. Third, it would reduce the risks of the Federal Reserve, a particularly important concern, since many of the risks to which it is exposed arise from international transactions initiated by institutions outside of the Federal Reserve's regulatory jurisdiction. Finally, with automation of the clearing and settlement system and value dating of transactions, it would be a simple matter to establish a queue for payments from individual banks. Those with adequate clearing balances would have transactions that would clear more rapidly than those that did not, again adding an element of market discipline to the system.

Risks in ACH systems are essentially the same as the risks in a wire transfer system. Again, they arise because funds are usually made available to the receiving institution on the day of settlement, but funds are not actually paid until late in the settlement day. Unlike wire transfers, however, if an institution fails on the day of settlement before settlement actually has been made, ACH transactions will be reversed by the Federal Reserve. In such instances, the receiving bank is at risk as well, since funds advanced by the Federal Reserve on settlement day may be reversed. In the check system, the principle risks faced by the Federal Reserve are that the sending institution may not be able to settle and that the Federal Reserve will be left holding items to be returned to an institution that had failed.

The Federal Reserve's risks on the book-entry securities system are similar to those on Fedwire. In particular, if the receiving bank has insufficient funds at the end of the day to cover the securities purchased, the Federal Reserve is in the position of having to extend credit to the bank.[73] One difference between book-entry securities

72 See Ireland (1986).

73 The extreme case where this happened was in November 1985 when the Bank of New York's computer system malfunctioned and the Federal Reserve made a $22 6 billion dollar loan to the bank until the problems were fixed Apparently, there were nontrivial problems in collaterizing that loan. Daylight overdrafts on government securities transactions run about $55 to $60 billion per day.

transfers and Fedwire payments is that in the former the Federal Reserve did transfer securities to the receiving bank and should have a security interest in the Treasury securities that had been purchased and transferred. As Ireland (1986) points out, however, perfecting that interest may not be straightforward since the party for whose account the securities may have been purchased also has an interest in the securities.[74] In addition, since it may not be clear what securities in the bank's own account the bank actually has a perfected security interest in, eligible collateral may not be readily available to use as security for a discount window loan. To date, although under current consideration, the Federal Reserve has not established caps for overdrafts in connection with government securities transfers to limit its risk exposure, similar to those instituted for Fedwire transfers. It has, however, limited each government securities transaction to $50 million.[75]

Risks in the payments system are presently greatest in the private systems that have net settlement and do not have finality of payment.[76] In CHIPS, for example, payments are not considered final until settlement has occurred. No third-party guarantees payments that have been put into the system, as the Federal Reserve does with Fedwire. Thus, if an institution participating in the system were to fail, all payments made by and to that institution during the day would be reversed, and settlement for the rest of the system would be recalculated minus the failed institution. Such systems are subject to systemic risk, since the removal of one failed institution from the system may affect the positions of one or more institutions in the system and could make them unable to settle. In the case of CHIPS, if settlement for the system is not possible, then all payment for the day would be reversed, which is tantamount to failure of the system.

Net settlement on CHIPS and most of the private clearing houses is accomplished at the end of the day by exchanging balances at the individual clearing banks and finally through exchange of reserve balances among the clearing banks at the Federal Reserve. The inability of one of the clearing bank's customers to be able to settle

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74 When perfecting a security interest is possible, price risk on the securities remain.

75 See Kantrow (1987).

76 See Huertas (1986) and Humphrey (1986)

would be handled in one of two ways. Either, the net debit would be covered through an extension of credit by the clearing bank, or if the customer were a bank, then the transactions to which that bank was a party during the day could be reversed. Unlike Fedwire, where the Federal Reserve guarantees finality of payment, the lack of finality of payments on the private clearing systems is the source of systemic risk and raises the possibility of a wholesale collapse. Systemic risk arises since backing out payments would change the net settlement positions of other banks, perhaps making them unable to settle. If the clearing banks are unable to cover the credit, then it must either be covered by clearing bank borrowings from the Federal Reserve or else the system cannot settle. Thus, the Federal Reserve is faced with the prospects of having to rescue the private systems for which it provides the settlement services, and it is the ultimate source of credit and bearer of risk for both the publicly run and privately run clearing systems.[77]

The large dollar volumes of transactions involved in the dominant components of the nation's payments system approach an average volume of a trillion dollars daily and far exceed the capital of the banking system or its ability potentially to deal with systemic problems in the payments system. These systemic problems, as described, would not appear to be affected significantly by the governmental support structure put in place to protect the check clearing system. Deposit insurance, for example, is essentially irrelevant, since the accounts transferred are not federally insured. Moreover, most demand deposit accounts are evolving into zero-balance accounts. The systemic problems in the large dollar payments systems relate to possible disruptions to the flows of funds through the payments system and not the stock of funds in the payments system or in clearing institutions.

Maintaining the integrity of payment flows is a substantially more complicated and difficult problem than protecting the stock of demand deposits for a number of reasons. First, given the large size of the

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[77] As Huertas (1987) points out, the principle risks in these private systems stem from the net settlement policy and lack of finality that places the receiving bank in the position of extending credit to the sending bank until settlement occurs. To attempt to control these nsks, CHIPS has established a net debit cap on the amounts that one bank can owe to other banks in the system. In addition, individual banks establish limits on the net amount of payments to accept from any one sending bank

transactions in the system and the size of the system itself, the resources required to support an unwinding of even a short-run problem may be very large, and could exceed the capacity of the private participants to self-insure themselves. The overnight extension of loans of $22.6 billion to the Bank of New York is an example of the sums that could be involved. Second, because the transactions are electronic and occur instantaneously, monitoring the transactions and the net position of each participant is critical to controlling credit-risk exposure by participants and the Federal Reserve, presently the ultimate creditor in both the private and public systems. Third, many of the risks that the Federal Reserve faces in its payments system activities are derivative risks that flow into the system because bank customers may be initiating transactions for which they suddenly may not be able to pay, which would only become obvious when the clearing banks would be unable to settle. These derivative risks might be domestic or international in their origin, and in the case of foreign risks, are beyond the jurisdiction or control of U.S. authorities. Fourth, because of the international character of CHIPS, failure of non-U.S. banks to be able to settle could cause the collapse of CHIPS, which in the process of unwinding transactions could also affect the domestic payments system, as well. In such circumstances, the inability of the ultimate creditor to control or monitor the risks posed by foreign institutions, except by limiting net exposure to the system at any one time, puts the Federal Reserve in a difficult position. Fifth, when the international activities of U.S. banks and the links between our domestic payments system and the foreign banking organizations are recognized, it becomes difficult to conceive of ensuring domestic financial stability without also ensuring international financial stability. Sixth, much of the present risks that are part of the large dollar payments system are in large part functions of system structure and design. Putting the system on a real-time basis and eliminating net settlement policies, which is becoming feasible with current technology, would eliminate the large overdraft and credit risk problems that are the core of the payments system risks today. Eliminating the credit features of the payments system would make it function similar to futures markets, where the operator of the system has virtually no risk exposure. If this were to be done for the payments system, then the question arises whether operating the switching and accounting mechanism is a proper governmental function.

Some deposit insurance reform issues

It has been argued that the present deposit insurance system may be becoming less relevant as a mechanism to ensure the safety and soundness of the financial system. As the costs of converting financial assets from one form to another decline, it becomes less and less certain what a transaction account is. In the extreme, if electronic barter becomes prevalent, then there is really little need to maintain a transaction account at all, and it is not at all clear what assets, financial or nonfinancial, should be insured. In such circumstances, the function of deposit insurance becomes one of providing a risk-free asset for those individuals that do not have access to a diversified portfolio or for whom transaction and information costs remain high. Arguably, this is the very function that deposit insurance was to address when it was instituted during the Depression. However, it is difficult to argue, especially in the present financial environment, why the U.S. government should provide wealth insurance in this way. Granting a government guarantee to a private institution today is discriminatory and it introduces distortions into the financial system. When the guarantee is mispriced, as it presently is, then the contract increases the risk in the financial system and requires a costly system of regulation and monitoring. Even if the system were properly priced, theoretical research suggests that regulation would still be required, and this would tend differentially to handicap and advantage competitors in financial service markets. Finally, if it is determined that wealth insurance is a proper governmental function, than offering small denomination government debt instruments to the public would be a much less costly and more effective way to accomplish the same purpose.

Conclusions

This paper argues that the process of financial innovation, technological change, and deregulation have significantly changed the structure and character of the U.S. financial system. By inference, there is no reason to believe that the changes we are observing will be slowed or that the fundamental underlying economic forces driving those changes will be less important in the future than they have been in the past. Several important observations are made. First, the key attribute of the changes we have observed is the continued erosion of market imperfections that have given financial intermediaries the opportunity to operate profitably over the direct credit markets. As the result of these changes, bank liabilities no longer perform their same unique functions in the nation's payment system as transactions and information costs are lowered. Second, because of internationalization and the integration of the U.S. and foreign financial sectors, new risks are introduced and these cannot be ignored in designing regulatory reform proposals. Moreover, the ability of financial institutions to engage in structural arbitrage means that it is no longer possible to constrain our domestic institutions through regulation without (1) creating opportunities for foreign institutions to achieve a competitive advantage in our domestic markets, (2) providing incentives for the domestic customers to seek lower cost alternatives abroad, or (3) driving our domestic financial institutions abroad, where they may be less constrained. Third, concerns for maintaining the safety and soundness of the payments system differ significantly from those that were relevant when the present regulatory structure was put in place. Deposit insurance in its present form is becoming less and less relevant to ensuring the safety and soundness of the financial system, and these problems will not be solved by simply changing the methods by which we price deposit insurance. Fourth, the primary concern in maintaining the safety and soundness of the payments system is assuring the integrity of the flow of payments through the payments system rather than stabilizing the stock of a particular financial asset. The principal risks that the payments system faces are uncontrolled credit risks, which arise primarily because of the way public and private systems operate. Net settlement policies and lack of finality of settlement are the chief sources of credit and systemic risks in the system as financial assets are exchanged. These could be dealt with by requiring continuous monitoring and settlement. These changes, which would reduce the role of the Federal Reserve and lower its exposure to derivative credit risks flowing from international markets, also raise the question of whether there is a role for the Federal Reserve in operating what would then amount to an electronic switching and accounting system.

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Commentary on "Eroding Market Imperfections: Implications for Financial Intermediaries, the Payments System, and Regulatory Reform"

Edward J. Kane

Discussion thrives on controversy and controversy thrives on difference. Because Robert Eisenbeis and I have similar views on many current issues in financial reform, clarifying our differences is inherently a fussy task. To make the contrast as sharp as possible, I am going to recast his ideas into two sets of stylized syllogisms and supporting argumentation. The goal of this exercise is to identify logical weaknesses that verbal reasoning might otherwise tend to obscure.

Syllogisms

Readers whose symbolic logic is rusty may find it useful for me to review what a syllogism is. A syllogism is a carefully constructed triad of related sentences. The first two sentences are premises: assertions whose truth or falsity a researcher must establish separately. These assertions are called a syllogism's major and minor premises, respectively. A syllogism's final sentence is called the ***conclusion*** because it is implied by the premises. If the premises of a well-constructed syllogism are true, the conclusion must be true also. Symbolically, the canonical form for a syllogism may be written as follows:

$$A = B \text{ (major premise)},$$
$$B = C \text{ (minor premise)},$$
$$\therefore A = C \text{ (conclusion)}.$$

A syllogism can be unsatisfactory for either of two reasons. First, a logical defect (or fallacy) may exist in the statement of the premises. Second, the evidence presented may be insufficient to establish empirically the truth of the premises assumed.

Professor Eisenbeis offers two broad conclusions: (1) that over time deposit institutions are becoming economically less viable, and (2) that this trend threatens "the stability of financial markets and the payment system" in ways that require regulatory reform. The existence of two conclusions presupposes two syllogisms. For convenience, we may call these the viability and stability syllogisms. By stating his implicit syllogisms explicitly, I hope to identify the controversial elements in his supporting arguments and to underscore the particular points on which Eisenbeis and I have different perspectives.

The viability syllogism

In the viability syllogism, the major premise is that market imperfections completely explain the existence of deposit institutions. The minor premise is that all relevant market imperfections are being reduced as well as transformed by technological change and evolving market conditions.

Eisenbeis justifies his major premise by an appeal to authority. However, while it is clear that various imperfections are *sufficient* for deposit institutions to exist, the logical necessity of the particular set of imperfections on which he focuses his paper ought to have been established more firmly. Skipping this logical step creates unacknowledged problems in proving part of the minor premise. To demonstrate his minor premise fully, Eisenbeis would need to list all relevant imperfections, to consider the extent to which movements in one type of imperfection tend to induce movements in another, and to evaluate the direction, extent, and interdependence of recent empirical movements in each type of imperfection.

Eisenbeis explicitly names three types of imperfections in financial markets as relevant (transactions costs, asset indivisibilities, and asymmetric and costly information), and his discussion goes on to develop an even more-important fourth imperfection (regulatory interference). He views government and private regulators as implicitly levying ***positive*** taxes on deposit institutions, and views regulatees as energetically attempting to avoid associated net tax burdens.

Eisenbeis implicitly parameterizes the idea of decreases in the first two types of imperfections and discusses movements in them in great detail. As a result, his claims that transactions costs and asset indivisibilities are lessening prove very persuasive. Unfortunately, his discussion of the other two types of imperfection is less disciplined. Because Eisenbeis does not stop to define either information costs or regulatory interference operationally, he is not led to produce direct empirical evidence on the extent to which the distortions they induce are increasing or decreasing. Instead, evidence of an increasing fusion of financial markets and activities (as exemplified by globalization of important financial markets, expanding product lines at U.S. financial-services firms, disintermediation, and stripped securitization) is taken as indirect evidence that relevant market imperfections must have decreased at least on balance. This leaves open the possibility that (as I believe) information costs and regulatory distortions may actually have been increasing in recent years and have done so partly in response to changes in transactions costs and asset indivisibilities.

Eisenbeis' discussion of movements in information is too brief. Without offering direct supporting evidence, he merely asserts that improvements in the flow of information "make it easier for lenders to assess the risks of dealing with offshore borrowers." Although I would agree that accounting and stock market information moves more freely and speedily than ever, I think that increased volatility in interest rates and foreign-exchange rates has made it economically far harder to interpret both traditional cost-based accounting records and (in view of the implied volatility of unmeasured conjectural government guarantees) even stock-market information. The increasing value of finding ways to extract inside information on firm value is underscored by trends in takeover activity, associated insider-trading scandals, and the size of monitoring and distribution fees collected by specialized financial-analyst firms. As shown by efforts to deny and then to understate the Federal Savings and Loan Deposit Corporation's developing economic insolvency, some of the most stubborn inadequacies in public information flows trace to financial regulators' and politicians' self-interested endeavors to conceal adverse information about the poor quality of their joint regulatory performance. At least as long as market-value accounting for deposit institutions can be forestalled, information about poor regulatory performance can be suppressed and even transformed cleverly into a plea for additional regulatory powers and an incremental budget with which to implement these powers.

In his analysis of regulatory competition, Eisenbeis overlooks the possibility that regulatory competition can transform small positive regulatory burdens into large net subsidies. This is because he barely confronts what I take to be two essential issues. First, he only sporadically links observed regulatory adjustments endogenously to movements in the other types of imperfections. Second, he neglects the political economy of regulation, leaving out the profound incentive conflicts that lead politicians and regulators to offer client financial-services firms addictive regulatory subsidies that are not in the economic interest of ordinary taxpayers (Kane, 1987). To analyze the future viability of deposit institutions, it is necessary to recognize that politicians and regulators earn rents both from hiding adverse information and from delivering subsidies selectively to regulatory clients. Because regulation can act as a subsidy as well as a tax, the economic viability of even such deeply insolvent firms as zombie savings and loan associations cannot be properly evaluated without including the endogenous responses of taxpayers, politicians, and competitive regulators.

Incorporating these political-economy factors leads me to view the uneven growth Eisenbeis cites in offshore lending as reflecting heightened international competition among inappropriately constrained government regulators in many countries. Far from being supported by improved information flows, the bulk of the credit risk in expanded offshore activities has been shifted conjecturally to underfunded regulatory agencies and to the taxpayers in various countries that ultimately back them up.

In competing for clients, government regulators have two complementary advantages over private suppliers of regulatory services. The reputational capital that government status confers cuts government regulators a great deal of slack. It permits their agencies both to bear the financial strains of predatorily subsidizing critical elements in their regulatory-service package for years on end and to manage self-interestedly the short-run flow of information concerning the effectiveness and cost-efficiency of their regulatory performance. In particular, they enjoy an option not to measure and not to report important implicit costs that are generated by their operations. In effect, governmental status gives an agency conjectural backing from the government at large that puts "added weight" behind its *financial* and its verbal claims.

This added weight makes it easier for agency managers to run the operating deficits necessary to support a strategy of "addictive subsidization" and to hide these subsidies from taxpayers for long periods of time. In effect, agencies use promotional subsidies and predatory news management to create and sustain an inefficiently large demand for their products. In the private economy, addictive subsidization is employed by dope dealers who regularly give away samples of their products to first-time users.

We can cite two strong examples of this marketing strategy in action. First, in financial services, successive Federal Reserve subsidization of its check-clearing and electronic transaction services has served to restrict the growth of competing private entities. Similarly, federal deposit-insurance subsidies have increased deposit-institution risk-taking and kept or driven state and private suppliers largely out of the game.

It is important to realize that regulatory subsidization is only half of the strategy. The second half is that inefficiences created by these subsidies (remote disbursement, high intraday volume of electronic clearing and overdrafts, and the spread of zombie deposit institutions) are transformed by "predatory news management" into justifications for expanding the subsidizer's jurisdiction. In effect, crises are created in lagged fashion by inefficient policies instituted by one set of regulators and legislators. Then, their successors "mine" resulting crises for new powers by scare tactics in ways that distract the public and would-be critics from the true causes of policy failure. Reformers should seek to eliminate distortionary regulatory subsidies and not to overlay additionally distortionary countermeasures.

The stability syllogism

With this as background, it is relatively easy to discuss the stability syllogism. Eisenbeis' major premise is that competitive pressures and declines in market imperfections have greatly increased the risk of economic insolvency facing individual deposit institutions. His minor premise is that parallel innovations in the ways that payments are typically made have created uncontrolled credit risk ***for the system*** that have outmoded the present regulatory structure (particularly deposit insurance) as a way of managing the safety and soundness of the financial system. His conclusion is twofold: (1) payment system risk should be attacked by the Federal Reserve's undertaking real-time monitoring aimed at eliminating daylight overdrafts, and (2) explicit government deposit insurance should be phased out.

I regard this syllogism as logically defective. It leaves out the role of Fed subsidies in creating payments systems risk and what I regard to be the key element in the ***de facto*** federal financial safety net. This key element is authorities' dual option to extend their guarantees of a troubled firm's liabilities beyond their ***de jure*** limits and to permit economically insolvent institutions to continue in operation. Ending explicit deposit insurance will not eliminate conjectural guarantees and the distortionary subsidies these options engender. Political, bureaucratic, and career self-interest makes it virtually inevitable that authorities prefer to forbear from enforcing solvency requirements and deposit insurance coverage limits when they perceive that the ***de jure*** failure of a firm or set of firms would threaten the stability of the financial system as a whole. During the last 22 years, examples of this behavior have abounded in the savings and loan industry. The Federal Deposit Insurance Corporation's treatment of energy, agricultural, and world-class (or too-big-to-fail) banks exemplifies the same proclivities.

Politicians and regulators value the opportunity to bail out insolvent deposit institutions on an ex post basis and the 1987 financial-reform act shows no readiness to give up this right. As long as authorities'retain an unlimited option to forbear, deposit insurance will exist ***de facto,*** at least on an implicit and conjectural basis. Eliminating explicit deposit insurance, as Eisenbeis recommends, is a narrowly legalistic solution as opposed to a fully realistic one. It would not solve the problem of pricing and administering federal guarantees of deposit-institutionliabilities. It would simply eliminate a familiar mechanism for collecting user fees from deposit-institution recipients of conjectural federal guarantees.

Strategic forbearance is institutionally advantageous for deposit-institution regulators and disadvantageous for the federal taxpayer. Underpricing and inefficiently administering the Federal Reserve's clearing and settlement system, the discount window, and deposit-insurance guarantees can be seen as a series of regulatory "treatments" and supplementary regulations designed to keep these systems from breaking down as forms of "countertreatment." Like the sequential administration of a poison and its antidote, the treatments and countertreatments are far from costless. Moreover, because each has unintended side effects, their simultaneous application is by no means distributionally or allocationally neutral. Taken together, they expand the demand for regulatory services and unnecessarily enlarge the role that federal agencies get to play in our country's financial life. In the final analysis, then, massive deposit-institution insolvency threatens ***not*** the stability of the nation's financial system but the net worth of its taxpayers.

Prospects for meaningful reform of financial regulation

Financial change is creating a desperate need for U.S. financial regulators to develop better information, monitoring, and policing systems. However, before taxpayers can rationally rely on politicians and regulators to operate these systems appropriately, they must reform the incentive system under which these agents operate.

The chief problem blocking meaningful reform of the U.S. financial regulatory system is that existing patterns of federal subsidies create business for regulators and rents for elected politicians. The agency problems exist because badly informed taxpayers have allowed competing government regulators an opportunity to adopt inappropriately constrained jurisdiction-maximizing strategies of competing with each other for potential clients.

Whether they recognize it or not, financial reformers seek implicitly to impose uncompensated costs on politicians and regulators. Without appropriate compensation or the introduction of behavior-modifying punishments, it is unreasonable to expect politicians and regulators either to surrender their existing job benefits or to stand up to the political and bureaucratic pressures that would be unleashed by the sectors that currently enjoy subsidies if progress were made toward rationalizing the system.

The root problem is to constrain government regulators to play fair with taxpayers. **A** minimum first step is to force a full accounting to taxpayers of the economic costs of each agency's operations and commitments. Without external coercion, government managers have little reason to reveal the market value of the operating losses inherent in jurisdiction-expanding patterns of long-lived subsidization.

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Financial Restructuring: The Canadian Experience

Charles Freedman

In this paper, I examine the recent Canadian experience with financial restructuring. In the first section, I lay out the background situation in Canada, which was quite different from that of most other countries. This is followed by an examination of the factors that were crucial in motivating the major overhaul in legislation in which we are currently engaged in Canada. The third section presents the approach taken by the Canadian authorities in dealing with the perceived need for change, in particular the mechanisms proposed to cope with the problems thrown up by the changes in structure. The final section sets out briefly the current situation regarding the legislation.

Background

Unlike the case in most countries, the drive for financial restructuring in Canada was totally unrelated to pressures for the removal of interest rate ceilings, credit controls, or other such quantitative restrictions. Indeed, since the 1967 revision of the Bank Act removed interest rate ceilings on bank loans, interest rates on both deposits and loans have tended to move with market interest rates and Canada has thereby avoided artificial inducements for the development of new instruments and new intermediaries to evade interest rate restrictions.[1]

Historically, the Canadian financial system has been based on five principal industries or groupings. The chartered banks, all federally chartered, were always involved in commercial lending and, in the last three decades, have also moved into personal loans and residential mortgage lending in a major way. Trust and mortgage loan companies tended to specialize in residential mortgage lending but more recently have been moving aggressively into consumer loans and certain forms of business lending. Most of these institutions are federally chartered but some operate under provincial charters. The cooperative credit movement (credit unions and caisses populaires) has principally serviced the personal sector with both mortgages and loans, although recently it, too, has been moving gradually into business lending. On the deposit side, all three of the above groupings have competed strongly for personal business over the past two decades by offering a full range of deposit instruments, and more recently competition has also been increasing for business and government accounts, once largely the preserve of the chartered banks.

The life insurance industry has moved over time from a traditional business involving the selling of life insurance and investing the proceeds in a mix of mortgage loans and investments, to a much greater emphasis on single premium deferred annuities, which closely resemble term deposits at the other institutions, and a more diversified portfolio of assets. This industry is split among federal and provincial jurisdictions, with the large majority holding federal charters. Finally, securities dealers in Canada are very much like their counterparts in the United States, with the exception that the legislative framework under which they have operated has been established by the provinces and not the federal government.[2] In recent years the separation of banking and the securities business has come under increasing pressure as a growing share of the short-term financing business of the corporate sector has been done through paper markets and as banks have entered the discount brokerage business.

Thus, although the Canadian financial system has traditionally been

[1] The considerable Innovation in the area of new financial Instruments that has occurred in Canada has been the result of such factors as interest rate volatility, uncertainty regarding future rates of inflation, shifts in borrower and lender preferences, and new developments in technology and communications.

[2] In addition to the financial industries discussed in this paper, there are also a property and casualty insurance industry, a pension industry, and a variety of less regulated or unregulated industries, such as the sales finance industry, the mutual fund industry, and the venture capital industry

characterized by a separation of functions among different types of institutions, the separation was never watertight, and in recent years there has been a more or less continual blurring of functions as institutions penetrated each other's areas.

For much of its history the financial system was also characterized by a large degree of separation of financial firms from those engaged, in nonfinancial business and by widely held ownership of the principal financial institutions.

One way in which the separation of commercial and financial business is built into law is in terms of restrictions on the downstream linkages that are permitted to financial institutions. Thus there are stringent limitations on the holding of equity investments by deposit-taking institutions and life insurance companies,[3] and securities dealers have traditionally not made long-term investments for control purposes in unrelated businesses. There is, of course, a grey area as to what is financial and what is commercial, and institutions are permitted to engage in what have been defined as ancillary activities. These include, for example, certain kinds of activities related to real estate, leasing, and payroll services, as well as the sale of data processing services in the case of trust and insurance companies but not in the case of banks.

Upstream linkages between financial institutions and commercial firms were limited by a tradition of widely held ownership for banks, and until recently, for most large trust companies. This was buttressed by a Bank Act revision in 1967 that mandated widely held ownership for banks by limiting the holdings of any one individual, firm, or group of associated individuals or firms to 10 percent of bank voting equity.[4] By their nature cooperative credit institutions are not susceptible to upstream commercial links; nor are the mutual life insurance companies, which are effectively owned by their policyholders. And until recently, only those individuals actively engaged in the securities industry could be partners or shareholders in a securities dealer. Even

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3 The principal situation in which banks can be involved in the ownership and operation of commercial firms is that in which the latter is taken over as collateral for a loan that is called. The bank is given two years to dispose of as holdings in these circumstances, although extensions may be granted by the Minister of Finance.

4 The intention of this legislation was to prevent any potential foreign takeovers of Canadian banks but it had the side-effect of preventing commercial-financial links from developing in the banking industry.

when the use of outside capital was permitted, restrictions were placed on the amounts that could be held by any one outside investor.

Thus, the only potential upstream linkages were in the trust industry and in stockholder-owned life insurance companies.[5] Many of the small firms in these industries were owned by commercial firms, but most of the large firms were widely held. In the case of trust companies, the situation has changed drastically in the last few years, during which all the major widely held trust companies have been taken over by commercial concerns. Many of the purchasers have also bought life insurance companies, thereby creating ownership links between insurance companies and trust companies. In some cases they have also established or purchased property and casualty insurance companies, investment banks, and real estate brokers, thereby creating diversified financial conglomerates.

The picture in recent years, in short, has been one of a sector in flux, with increasing interpenetration by the various industries of each other's traditional domain, the development of financial-commercial upstream links through takeovers, and the common ownership of some trust companies and life insurance companies as these acquirers broadened their activities.

Factors motivating the legislative restructuring of the system

Although elements of the changing structure sketched out above provided the initial pressure for a major legislative restructuring of the system, other factors also came to play an important role over time in intensifying the perceived necessity for change and conditioning the nature of the change. One can identify five key factors that drove the process. First, there was a need to modernize the legislation of trust and mortgage loan companies and of life insurance companies and to deal with the question of the business powers available to each of these groups. Second, in the light of the spread of closely-held ownership, commercial-financial links, and common ownership of firms in different industries, there was a need to re-examine potential problems of self-dealing, conflicts of interest, and concentration

5 There were also considerable upstream linkages in the property and casualty insurance industry.

of ownership as well as the broader question of the desirability of financial-commercial links. Third, given the recent failures of a number of financial institutions, including two small Western Canadian banks, questions were raised about the incentives created by the system of deposit insurance in Canada, and about the adequacy of the supervisory structure. Fourth, as the process developed, there was increasing attention paid to the ongoing globalization of financial markets and the need for Canadian financial institutions to be able to compete effectively both at home and abroad. And fifth, at the same time as the federal government was developing its approach, the provincial governments were taking their own initiatives, both developing new legislation for the institutions under their aegis and acting to change the entry rules for the securities industry.[6] The initial impetus for restructuring the financial system came from the first two factors while the other factors came into play over time as the process was going on. I now turn to a detailed discussion of each of these factors.

Need to modernize legislation and the pressure to expand powers

Whereas, by law, the legislation governing banks is updated every ten years, the federal legislation governing trust companies had not been completely overhauled since 1913 and that governing life insurance companies since 1932.[7] Interestingly, most of the pressure in Canada for expansion of the business powers of deposit-taking financial institutions in the recent period have come from the institutions themselves. With some minor exceptions, there has not been much in the way of complaints by customers as to the availability of services, nor any great apparent demand for financial supermarkets. To a great extent, the desire of these institutions to expand their range of permitted services (especially in the area of commercial lending)

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6 The crucial element here was the discussion about entry of other financial institutions and foreign dealers into the domestic securities industry.

7 This is not to imply that no changes had been made over the intervening period. Important amendments to the legislation and changes in regulahons had given these institutions a gradual and considerable increase in powers over the years such that for most of the period they were able to engage in the lines of business they wished to enter.

derived from their experience with the difficult financial markets of the late 1970s and early 1980s, which left the institutions concerned that they might not have the flexibility to cope with the situation that might evolve over the following decade. The key elements involved in the case of the trust companies were, first, the shortening of the maturities of deposits that had occurred in the face of uncertainty and interest rate volatility and, hence, the desire by the institutions to be able to lay off these funds in floating rate and short-term assets,[8] and, second, a concern that their primary asset, residential mortgages, would over time become less important for demographic reasons. There was, therefore, a strong desire to expand their activities in commercial lending. At the same time, life insurance companies were shifting their activity away from life insurance toward short-term deposit-like instruments and, consequently, they wished to be able to diversify their assets more widely than in the past in order better to match. In addition, they wanted to be able to purchase or set up trust companies in order to expand the scope of their activities.

A related element of pressure for change, which became important at a somewhat later stage, came from the desire of banks to enter into the securities business in Canada. In part, this was a reflection of the trend by corporate borrowers away from bank loans to securities markets and the banks' consequent perceived need to increase their fee-generating activities in lieu of intermediation income. Although some of the banks were already engaged in investment banking in jurisdictions outside of Canada and although banks were permitted to engage in certain types of securities activities in Canada, they felt that their ability to get involved to a greater extent in such business in their home market would enable them to service their domestic customers more effectively and would strengthen their capacity to engage in corporate underwriting and other facets of the securities business in international markets. In addition, there was some pressure to review the provincial regulations that prevented foreign entry into the domestic securities industry as well as some tendency to emulate related developments elsewhere, particularly in the United Kingdom.

[8] In Canada most commercial loans are made on a floating-rate basis related to the prime lending rate or, in some cases, to the cost of funds

Conglomeration, closely held ownership, and *commercial-financial* links

The other initial development leading to the process of change of the legislation governing the financial sector was the spread of the conglomerate movement to the financial sector. As mentioned earlier, nonfinancial firms had purchased financial firms and, in most cases, these new owners had gained control of institutions in more than one financial industry. Thus, some major trust companies and life insurance companies had been brought under common ownership and were closely held. As a result of these changes, policymakers became more concerned about the potential for self-dealing,[9] a problem that had not arisen in any major way until then, principally as a result of the tradition of wide ownership. Thus, one crucial goal of the restructuring exercise was to find a way of reducing the self-dealing risk in the case of closely held firms. Furthermore, with the interpenetration by industry groupings of each other's territories and the development of common ownership of different types of financial institutions, one could no longer rely upon compartmentalization of functions as a way of avoiding conflicts of interest.[10] As one moved into the "brave new world" in which institutions or groups of institutions with common ownership could carry on more functions, the question of how to deal with potential conflicts of interest came to the fore.

In addition to initial concerns about the self-dealing aspects of commercial-financial linkages, there developed over time a more

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9 The term "self-dealing" has been used in the Canadian context to deal with transactions between a financial institution and either its controlling ownership group or the nonfinancial interests of the ownership group. The concern has been that such non-arms-length transactions, whether asset purchases, loans, or guarantees, might in some cases be to the benefit of the owners and to the detriment of the financial institution, thereby increasing the rrsks to the depositors of the latter and to the deposit-insuring agency In extreme cases, such transactions might result in the insolvency of the financial institution

10 Conflict of interest issues arise when the interests of two customers of an institution can be in conflict or when those of the customer are in confltct with those of the institution itself An often-used example is the possibility that an institution would use the funds of a trust that it was administering to purchase securities of a firm to which it was lender and then use the proceeds to repay the loan The separatton of the trustee function and the commercial lending function had avoided this problem, but it has become essential to find other ways of dealing with it as financial institutions have become increasingly involved in both the trust business and commercial lending

general unease with such linkages, which was related to considerations of concentration of power and the impartiality of the credit process. Moreover, there has been some concern that problems in the nonfinancial part of a conglomerate could spill over and undermine confidence in the soundness of the financial institutions in the conglomerate.

Institution failures, supervision, and deposit insurance

In common with the experience in other countries, Canada has had a number of failures of financial institutions in the 1980s, including those of two small Alberta banks. These failures, which were very costly for the deposit insurance agency (and, in the case of the two small banks, for the government as well) led some to question the structure of the deposit insurance system. In Canada, deposits are insured for the first $60,000 and the premia charged all institutions are a fixed percentage of their insured deposits. Among the options that received the most attention in the debate were those of co-insurance and variable risk-related premiums.

The other offshoot of the institutional failures was a concern with the structure of the supervisory system and its ability to cope with the changing financial structure. In the case of banking supervision, Canada has always used a tripartite system that has relied on the bank's internal inspection systems reporting to the board of directors, on external auditors, and on the supervisory agency. The latter has relied upon financial statements verified by the auditors, and on-site inspections have played only a very limited role.[11] The question of whether the nature of the supervisory system itself bore some responsibility for the failure of the Alberta banks and therefore required modification was made the subject of a Commission of Inquiry.

Role of globalization

Although this issue was not especially prominent in the earlier part of the process, over time it came to have a much more central role

[11] This is similar to the situation in most European countries In the United States, in contrast, with its large number of small banks, on-site inspections play a central role.

in the thinking of the various participants in the debate. The principal question at issue in this regard was the potential direct entry into the domestic securities market of Canadian financial intermediaries and of nonresident banks and securities dealers.[12] Behind the debate was an increasing concern about the performance of the Canadian securities industry in a rather protected environment at a time of increasing competition in and from other major world securities markets.

A principal argument of those who supported change was that dealers needed more capital, particularly in a world of "bought deals" with greater than traditional risks. There was also concern that the Canadian securities market would become a backwater if it did not open up to the rest of the world and that more competition was necessary to ensure that the Canadian securities industry did not fall behind in a very innovative world environment. This concern was exacerbated by the fear that developments in communications, by reducing transactions costs, would permit an increasing share of Canadian lending and borrowing to be conducted outside the country if the Canadian securities industry was insufficiently efficient or innovative.

Provincial government initiatives

Recall that in Canada only banking is totally under federal jurisdiction. Although a large proportion of the trust industry and the insurance industry is federally chartered and regulated, some part of these industries falls under provincial jurisdiction as does virtually the entire cooperative credit industry and securities regulation. At the same time that the federal government was re-examining its approach to the financial sector, the provincial governments were revising their legislation as well. As the process developed there were three aspects of the provincial developments of particular importance. First, the province of Quebec moved down the path of permitting ownership of companies in one financial industry by those in another

12 Certain kinds of activities were open to both nonresident securities dealers and domestic financial intermediaries and, indeed, such institutions played an Important role in the so-called "exempt market".

industry. Second, there were apparent divergent attitudes by the federal and provincial governments regarding such issues as closely held ownership and financial-commercial linkages. Third, there was initially some considerable disagreement between Ontario, the primary regulator of the most important securities center in the country, and the federal government regarding the scope of entry by banks and other financial institutions into the securities business, as well as regarding the locus of regulation and supervision of federally chartered financial institutions that did enter into this business.

Approach taken to restructuring

In the course of preparing for the restructuring of the financial system, both federal and provincial governments commissioned and prepared a number of reports, and hearings were held by the House of Commons and Senate committees followed by the issue of reports. The federal government's own position was set out in two documents, an initial discussion paper entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion" (commonly known as the Green Paper), and a final set of proposals entitled "New Directions for the Financial Sector" (commonly known as the Blue Paper). Because it is the latter that has set out the framework for the legislation that has been and is currently being prepared, the approach in that paper is the focus of the rest of this discussion. Because the nature of the proposed changes continues to be the subject of intense debate, there may be modifications to the approach before the legislation is finally passed.

Powers

There is to be a very considerable extension of the business powers granted to financial institutions, both in the form of in-house powers and in the ability to invest downstream in other types of financial institutions. Among the most important of the changes is the right of trust and mortgage loan companies and life insurance companies to make consumer loans and business loans without specific quantitative limits.[13] In addition, subject to the rules regarding ownership which are discussed below, regulated financial institutions will be able to invest in, purchase, or start up institutions in other financial sectors, including the securities industry.[14] Institutions will also be permitted to engage in the networking of one another's products and to engage in a number of ancillary activities that were prohibited in the past.

There are a number of limitations to the general approach just outlined. First, large financial institutions will not generally be permitted to purchase large financial institutions in other areas, with the exception of securities dealers. This provision was aimed at preventing the reduction of competition through the merger of currently competing large institutions. Second, the retailing of insurance was excluded from the right to network. Third, the entry of nonresident institutions into the securities market, either directly or through investment in an existing securities dealer, was partly restricted until June 30, 1988. This was intended to give Canadian-owned financial institutions a short head start in entering into the securities industry. Fourth, the trade negotiations with the United States that are currently under way have included discussions of nonresident ownership of financial institutions in Canada, which may influence the final form of the legislation.

One result of the proposed changes is that the differences between the various types of financial institutions will be far smaller than in the past. Conglomerates will emerge that can provide virtually every kind of financial service to business customers or to personal customers or to both.[15] Institutions that choose to remain stand-alone

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13 To qualify for the right to make business loans without limit, however, a near-bank must have reached a minimum size in terms of capital and have received supervisory approval Furthermore, the institution would be bound by considerations such as diversification which are part of the usual prudent portfolio approach to portfolio management.

14 Thus, the Canadian equivalent of Glass-Steagall, by which deposit-taking institutions and securities dealers were kept separate, is being abolished as part of the restructuring In addition to the right to invest in securities subsidiaries, banks and near-banks will be permitted to engage directly in certain hitherto-prohibited types of activities, in particular the provision of Investment advice and portfolio management services

15 The legal structure of the conglomerates may vary significantly since the law will permit but not require a financial holding company, and institutions can invest downstream in a partly or wholly-owned affiliate. Thus the peak of the pyramid may be any one of the regulated financial institutions or a financial holding company.

will also be able to offer, if they choose, most kinds of financial services, either directly or as an agent. The somewhat blurred distinctions of the past among different types of financial institutions will, for the most part, come close to disappearing. Of course, some institutions may continue to specialize in one or more areas, offering a boutique-type service in their area of special expertise.

One byproduct of giving banks and near-banks very similar powers in the domain of lending was the need to address the issue of competitive equity regarding the imposition of non-interest-bearing reserve requirements on banks and not on near-banks. The decision was taken to phase out reserve requirements on the banks so as to remove the unequal treatment and unequal costs on institutions competing for the same business. The Bank of Canada does not perceive the necessity for any major changes in the implementation of monetary policy as a result of the abolition of reserve requirements. Major financial institutions will continue to settle their accounts on the books of the bank and hence will continue to hold deposits at The Bank of Canada. This will provide a sufficient fulcrum for the operation of monetary policy.

Ownership

In many ways, this is the most complicated part of the proposals because it attempts to integrate a desire to limit financial-commercial linkages with a recognition of the present reality. In effect it divides financial institutions into three types—widely held, closely held with no commercial links, and closely held with commercial links. It also distinguishes, primarily for historical reasons, between banks and near-banks.

Banks. No commercial links are permitted. Existing large banks must remain widely held. Small banks can be closely held but when they reach a certain size ($750 million in capital) they must ensure that, within five years, at least 35 percent of their shares are widely held and publicly traded. Furthermore, large shareholders cannot increase their equity holdings in such a bank. Thus, over time, the proportion of ownership of the controlling shareholder will be diluted as new shares are issued, until the bank becomes widely held.

Nonbanks with no commercial links. These may remain closely held until they reach $750 million capital, at which point they must ensure that, within five years, at least 35 percent of their shares are widely held and publicly traded. In contrast to the case of banks the controlling owners may maintain their share of ownership indefinitely by purchasing their proportionate share of any new issue of voting, shares.

Nonbanks with commercial links. Special, more restrictive rules will be imposed in order to constrain commercial-financial linkages. First, no approval will be granted for the incorporation of new trust, mortgage loan, or insurance companies to applicants with significant commercial interests. Nor will such applicants be permitted to increase ownership positions of more than 10 percent or acquire ownership positions exceeding 10 percent in financial institutions with capital in excess of $50 million. Second, for commercially-linked institutions (or groupings) with more than $50 million in capital, 35 percent of shares must be widely held and publicly traded within five years. The controlling shareholders may purchase their proportionate share of any new voting equity issues as long as the 35 percent threshold is reached within five years. Third, for very small closely held institutions (less than $50 million in capital), no changes are required.

This approach to ownership is intended to arrest the trend to greater links between the commercial and financial sectors and to encourage wider holdings of shares (at least to the 35 percent level). Nonetheless, the movement to widely held ownership will probably occur only very gradually.

Self-dealing

The concern about self-dealing is to be addressed through a variety of approaches. First, and foremost, there will be severe limitations on non-arms-length transactions between financial institutions and persons or companies who are in positions of influence over or control of the institution. The most important of these are transactions with shareholders who own more than 10 percent of the shares of the institution, with directors and officers of the institution, and with significant business interests of such persons. The policy bans most types of transactions with non-arms-length parties (including loans and investments, and sales and purchases of assets) and imposes internal controls for permitted classes of transactions (mostly service transactions). Second, transactions between regulated financial institutions will be restricted, but to a considerably lesser extent than those between financial institutions and their owners. Unusual transactions will require preclearance by supervisors. Third, the approach to ownership with its constraint on financial-commercial links will, over time, tend to reduce the situations in which self-dealing can occur.[16] Fourth, the combination of at least 35 percent minority shareholding and an enhanced role for independent directors should, on the margin, have a beneficial effect.

Conflicts of interest

Potential conflict of interest problems will be handled by a multifaceted approach that includes greater disclosure to the consumer, the use of techniques to prevent the dissemination of inside inforation within an institution (commonly known in financial circles as "Chinese Walls"), and enhanced internal scrutiny through creation of a monitoring group within each institution. The purpose of these elements is to identify potential conflicts, to provide for an appropriate internal process to deal with conflicts, and to require that proper disclosure be made.

Among the disclosure rules will be the following: clear identification of the institution with which the client is contracting, including the presence or absence of deposit insurance coverage of deposits; a clear description of the role played by the corporation in contracting with the client, including whether the corporation is a principal or an agent for other parties; a statement that fees and commissions are earned by the institution in networking situations; and disclosure to the client of any material facts coming to the knowledge of the institution in the course of a business transaction with or on behalf of a client.

[16] Some have argued that the ownership rules will potentially reduce the level of competition in the financial services industry. This may be a case where there is some tradeoff at the margin between competition and soundness and where the decision has been made to emphasize the latter

Corporate governance

In the area of corporate governance, changes with respect to auditors and directors will be put in place. Although the external auditors' role in the tripartite system will not be fundamentally changed, measures will be introduced to improve the quality of information flowing to them, to bolster their independence from the management of the financial institution, and to enhance their communication with directors and the supervisor.

Recognizing the important role that directors play in a financial institution, the intention is to make mandatory certain procedures that should improve the functioning of boards. To ensure that the board of directors has access to the views and judgment of individuals that do not have a significant association with the financial institution, it will be required that at least one-third of the directors be "independent" of the financial institution. Independent directors are also to be given an important role in reviewing the corporate practices of particular supervisory concern—for example, certain self-dealing transactions, conflicts of interest, and transactions or practices that may have a material effect on the health of the financial institution.

Supervision and deposit insurance

There have been and are to be a number of important changes to the supervisory and deposit insurance structure but these are not of an especially radical character. The two federal supervisory bodies, the Office of the Inspector-General of Banks and the Department of Insurance (which was responsible for supervising trust and mortgage loan companies as well as insurance companies) have been merged into a new Office of the Superintendent of Financial Institutions. This change is particularly appropriate, given the proposed changes in the powers of the various financial institutions that would make them much more similar than in the past. Other possible changes to the structure of the supervisory body that had been discussed in the course of the last two years, such as a merger with the deposit insurer or shifting supervisory responsibilities to the Bank of Canada, were in the end not considered to be as desirable. The supervisor was also given new powers, of which the power to make "cease and desist" orders is the most important. In addition, a new interagency committee will be established, consisting of the heads of the supervisory office, the central bank, the deposit insurance agency, as well the deputy minister of finance, which will ensure information exchange and consultation on supervisory matters that have implications for solvency, last resort lending and risk of deposit insurance payout. Also, by ensuring that the concerns of the deposit insurer and the lender of last resort are given full weight in decisions on troubled institutions, the new committee will strengthen the supervisor's "will to act" in these situations.

On the deposit insurance front, neither coinsurance nor risk-related premiums are to be introduced. However, the Canada Deposit Insurance corporation (CDIC) has been given increased powers in the issuance and termination of insurance coverage and it has been given the power to levy a premium surcharge on member institutions that are following unacceptable practices (as specified by CDIC bylaws). The insurer will also play a central role in restructuring insolvent institutions.

Current situtation

The legislation passed thus far includes that pertaining to the supervisor and deposit insurer, as just mentioned, and that permitting financial institutions to invest in or purchase an existing securities dealer or to start a new securities dealer subsidiary. The rest of the proposed changes, including those relating to institution powers, ownership, self-dealing, conflicts of interest, and corporate governance will be presented in the form of draft legislation later this year and introduced in parliament afterwards. Still unresolved are the issues being discussed in the free trade negotiations with the United States (in particular, questions of mutual access to markets pertaining to the involvement in the securities industry of banks, and of investment dealers having a bank connection) and some federal-provincial issues, particularly those regarding jurisdiction over securities powers exercised in-house by federally chartered institutions. Although the federal government reached agreement with Ontario over this issue, the other provinces have not accepted this agreement.

In the course of preparation of the legislation, it will be necessary to resolve some questions that still remain on major issues and to deal with the many details that were not covered in the government's policy paper. The changes currently under way to the financial sector are of such importance, in terms of establishing the framework for the financial industry for the next generation, that the process of discussion and legislation is bound to take some time before it is finally completed.

Financial Restructuring: The United Kingdom Experience

Anthony Loehnis

The City of London underwent a much publicized revolution on October 27, 1986, the so-called "Big Bang", which consummated far reaching changes in the structure and operation of our securities industry, based on a few highly significant changes in the rule book of our domestic stock exchange. It was, however, the culmination of many changes that had been taking place in the City since the 1960s, beginning with the growth of the Eurodollar market. While the changes in the securities market have been abrupt and discontinuous, those in banking have been evolutionary. This paper looks at the developments in both fields of financial activity and in their regulation, the linkages between the two and the prospects for the future.

In analyzing a process of restructuring, it is helpful to have a clear idea of what the original structure was, and how it had become so. The most convenient source for a description of the structure and operations of financial institutions in the United Kingdom in the 1970s is probably that contained in the Report of the Committee to Review the Functioning of Financial Institutions (Crnnd 7397), known as the Wilson Committee, published in June 1980. For purposes of this paper, however, I shall confine myself to discussion of the banking system on the one hand and the securities markets on the other, for these are the areas where the greatest changes have taken place and where some of the most difficult supervisory problems arise.

The banking system

As in the United States, the British financial system developed in the 19th century and into the second half of the 20th century along the lines of the provision of separate financial services and functions by separate institutions. This is in contrast to developments in continental Europe that have tended toward the evolution of the universal bank, providing a wide variety of fmancial services under one roof, in particular both banking and investment services. In one major respect, however, British and U.S. development has diverged. Since 1933, the Glass-Steagall Act in the United States has provided a statutory bar to the taking of deposits and the underwriting and trading of corporate securities within the same financial institution or group. There has been no legal requirement in the United Kingdom for such functional separation, and the operation of a wholesale banking business combined with the issuance and underwriting of securities has been the stock in trade in particular of the group of institutions known as merchant banks.

There was no particular theory or philosophy underlying this development—it was the result of the accidents of history. One of the most important influences, no doubt, was the development of London in the 19th century, following the Industrial Revolution, as the financial and commercial center of the world. This was an international environment in which the provision of specialist financial services was demanded and could flourish.

On the domestic side, developments were perhaps a little slower. Our existing clearing banks are, in the main, the product of a series of amalgamations of provincial banks in the 19th and early 20th centuries. They were amalgamations of disparate banks which, because of their growing geographical coverage within the United Kingdom as the Industrial Revolution spread, had evolved from partnerships into limited companies. In fact, for many years the alternative name to "clearing" banks was "joint stock" banks, to distinguish them from the traditional City of London-based merchant bank that continued to be operated as a partnership by the proprietors of the business, in most cases until after World War II. Because so many of the major houses, with illustrious names such as Rothschild, Baring, Lazard, and Schroder, originated as merchants from continental Europe whose expertise was rooted in foreign trade and its financing, the orientation of such houses remained international. From merchanting, through the finance of trade by accepting "bills of exchange," they moved to the provision and mobilization of capital for development and investment overseas through the arrangement and underwriting of stock issues and finally, often through the need for an organization to deal with the investment of the personal wealth of the proprietors, into the world of investment management.

The clearing banks long remained domestically oriented. Overseas activities were carried out through separate subsidiaries. The clearing banks provided money transmission services. Their speciality was the collection of bills of exchange and checks. The idle balances that were available were used to provide working capital for all sectors of the economy, but their need for liquidity led them to concentrate on short-term lending, although it became increasingly apparent that the overdraft system of lending contained within it a significant core of medium to long-term lending.

The differences in function between the clearing banks and merchant banks led to the development of two very different cultures: that of the clearing banker, domestically oriented, relying on a long-established and geographically widespread system for the collection of retail deposits and the making of credit judgments on the basis of local knowledge of customers; and that of the merchant banker, generally more internationally minded, mobilizing financial resources of others rather than lending his own and relying on entrepreneurial skills and flair to exploit new developments and opportunities.

The evolution of the banking system described above continued substantially undisturbed into the 1960s. The concentration of the clearing banks continued through amalgamations and mergers until there were four main groupings by 1968, while the 1950s were an active time for the merchant banks to incorporate from their traditional partnerships, with a number of them merging and becoming public companies.

It is important to remember that during the whole of the postwar period until 1979 financial institutions in the United Kingdom were subject to exchange control. This had the effect of drawing a ring fence around their domestic sterling activities, but leaving them, including the foreign-owned institutions established or setting up in London, free to conduct business in foreign currencies. This led to the paradoxical situation that the Eurodollar market that came into being in the 1960s became established in London, despite a very strict exchange control regime. The London merchant banks were early participants in, and developers of, the Eurocurrency markets, and it was to London that the major U.S. investment and commercial banks came, in many cases following their U.S. clients forced to utilize the Euromarkets because of the OFDI regulations introduced in the United States in 1968. With them, they brought the issuing techniques of the U.S. capital markets as well as innovative ideas in banking to challenge the prevalent conservative banking orthodoxy. The corollary of the establishment and growth of the Eurocurrency markets in London was the explosive growth of the number of foreign institutions established there, which increased from around 80 in 1965 to around 340 today.

It would be true to say that the clearing banks were rather slow to join the bandwagon, partly for cultural reasons and partly because their domestic development had not involved them in capital issues or securities underwriting or trading to any large extent. That situation did not last long, as they themselves established or acquired merchant banking subsidiaries and as the advent of syndicated bank credits in the Eurocurrency markets, which enormously outpaced the growth of the Eurobond markets in the 1970s as inflation took hold, brought them to center stage with their ability to deploy far greater resources than those of the merchant banks.

In many ways the inflationary experience of the 1970s was one of the most potent stimulants of structural change, alongside the gradual internationalization of financial markets, for it broke down the traditional distinction between long-term capital market finance and banking finance for working capital needs. For some time, and in a number of countries where it had not traditionally been the case, banks became the main providers of long-term funds to companies. The wheel may now have come full circle, with syndicated credits out of fashion and increasingly replaced on banks' balance sheets by floating rate notes and other forms of securitized lending. But the point is that the clearing and commercial bankers have increasingly learned the investment bankers' trade and techniques in the process. Separation of functions has broken down, and the gap between the two cultures referred to above, although still visible in a number of ways, has become much less significant.

Simultaneous with these changes on the international side of the

British banks' business, major changes were taking place on the domestic side, of which one of the most significant was the rise of the building societies as takers of deposits compared with the clearing banks. In 1964, the London clearing banks accounted for nearly **33** percent of the total domestic sterling deposit market, while the building societies, broadly equivalent to U.S. savings and loan institutions, had some 18.4 percent. By 1970, the percentage shares were almost identical, at around 29 percent each, and by 1978 the building societies had pulled steadily ahead to nearly 38 percent while the London clearers had fallen to below 27 percent. Changes in the statistical reporting system make subsequent comparisons difficult, but the building societies' share seems to have been fairly steady throughout the 1980s at just over 40 percent, with the clearers' share some 10 percent less. Foreign banks have raised their share from under 1 percent in 1964 to just over 5 percent in 1986.

The reason for the rapid rise of the building societies is not hard to discern. They have traditionally been the main source of finance for house purchases, and in the period 1964 to 1985 the percentage of owner-occupied dwellings had increased from 45 percent to 61.5 percent. Furthermore, preference in lending was given to those who deposited their savings with the societies, and this natural magnet for attracting householders' savings was enhanced by better marketing, more customer-oriented opening hours, simplified tax treatment for interest earned, and more recently the addition of checking facilities. The challenge of the building societies to commercial banks in a number of areas has, in fact, been facilitated by new legislation that extends the range of activities they may undertake. (See below.)

The role of the authorities

It is appropriate at this stage, however, to comment on the role of the authorities in the process of change just described, and in this context, the authorities essentially means the Bank of England. Their role has been basically noninterventionist. In general, the market has been allowed to develop in its own way and to serve its customers as it sees best, with rules being relaxed when competitive pressures made their continuance either an obstruction or an irrelevance. Until 1971, there was in theory a cartel among the clearing banks governing the rates paid on deposits and their terms, although in practice the banks had devised ways of bypassing the cartel through establishing a range of subsidiaries to offer better terms on deposits or other specialist services. The cartel was, nevertheless, tacitly supported by the authorities in those days, not least because it was seen to provide a means through which monetary policy and credit control could be applied to the U.K. domestic economy.

It became clear, however, in the late 1960s that the leakages in credit control were such that the subsidiaries of the clearing banks and all the other banks in the United Kingdom—domestic merchant banks and foreign banks—would have to be brought into a common system. Therefore in 1971, arrangements were introduced to abandon the cartel and to bring all banks onto the same footing in respect of the administration of monetary policy. The arrangements were known as "Competition and Credit Control'?, the title of an explanatory paper produced by the Bank of England, and their effect was to abolish direct controls on lending and to rely instead on the price mechanism.

Notwithstanding the Banking Acts of 1979 and 1987, there is still no legal definition of a bank in the United Kingdom. Prior to the 1979 act, several separate different authorizations from different authorities were available to banking companies, in particular in relation to taxation arrangements, the presentation of company accounts, and the administration of exchange control. But there was no statutory definition or description of a bank or of banking. In practice, the Bank of England chose those institutions that it wanted to classify as banks for credit control and national account purposes, who joined the so-called "authorized bank" category. In fact, the authorization related to engaging in foreign exchange transactions under the Exchange Control Act. Such banks were supervised by the Bank of England; others were not.

In the absence of formal authorization of deposit-taking businesses in this period, there had developed a number of "secondary banks," whose main objective had been to take advantage of the freedom from the panoply of official control for credit and monetary policy purposes to which authorized banks were subject. Following a sharp rise in U.K. interest rates in 1973, which led to problems in property financing, a number of these secondary banks found themselves in difficulties. The illiquid banks were sorted out from the insolvent, and under the auspices of the Bank of England liquidity support was provided by the commercial deposit-taking institutions and the Bank of England through what was commonly known as "The Lifeboat".

The Bank of England had at that stage no legal or even moral duty to protect depositors in these secondary banks. But the secondary banking crisis, and the European Community requirement to have a statutory-based system of authorization of companies taking deposits from the public introduced in 1977, led to the first formal legislation for the authorization of all deposit-taking institutions in the United Kingdom, the 1979 Banking Act, which also introduced a deposit protection scheme.

The focus of this legislation is the taking of deposits from the public. Following the U.K. experience with secondary banks, a distinction was made in the 1979 act between licensed deposit-takers (companies offering only a limited range of banking services) and recognized banks (offering a broader range). In practice, most of the existing commercial banks and investment banks were classified as "recognized banks" under this legislation, with the result that the size and scale of operations of deposit-taking institutions became a major element as to which side of the dividing line they fell. A further banking act has recently been enacted which builds on the experience of implementation of the 1979 act, and under this new legislation this distinction has been abolished (See below.)

Banks and other financial activities

Unlike in some other European countries, the activities that a bank may undertake are still not defined by statute in the United Kingdom. British banks are; at least in theory, free to undertake any activities, although of course-the banking supervisors do have some opinions on this subject and, particularly under the 1987 Banking Act, some powers to enforce these opinions. It is, nevertheless, worth noting that some affiliated companies of the British clearing banks (mainly subsidiaries of finance house/installment credit subsidiaries) have been involved in automobile distribution and repair, television rental, and even the manufacture of railway freight cars. They have been elatively small operations in relation to their main banking business.

From the supervisory point of view the most important aspect in such cases has been to ensure that the management of a bank fully understands the nature of any commitment it takes on, that the activity is run by people with the appropriate experience, and that the business, unless germane to banking and capable of being supervised on a consolidated basis, should be run at an arms length, i.e., there should not develop a banking relationship between the parent bank and its subsidiary. The reason for this is primarily that banking groups are highly dependent upon market confidence and normally stand or fall together. In other words, the slightest hint that something is amiss in one part of a banking conglomerate usually puts other parts at risk of a liquidity crisis. A secondary concern has been the need to ensure that undue influence is not brought to bear by one part of a group on the normal commercial judgments of another.

There have been, however, some areas of financial business that the authorities have positively discouraged banks from entering, albeit without any statutory backing for such action. The most significant of these has been insurance, where the authorities have generally sought to restrict links between banks and insurance companies, particularly those involved in general insurance. The banking and insurance supervisors' main concern has been the possibility of conflicts of interest between depositors and policyholders in the event of a problem occurring in either company and the risk of cross infection between the two activities. Both banks and insurance companies are highly geared compared with the generality of companies. Both are dependent upon public confidence for their continued existence and are at risk to liquidity and solvency problems. There is the risk that a liquidity or solvency crisis in one company would almost certainly require intervention by the other, resulting in the possible collapse of both. The discouragement has not, however, been absolute, and there are a number of comparatively large insurance companies with interests in small deposit-taking companies, and conversely, some of the large commercial banks own comparatively small insurance subsidiaries. What we want to avoid is insurance companies and banks of similar size forming links, but that would not necessarily preclude the building up of one within the other by organic growth, and in a few specific cases permission has been given for a significant minority stake in one to be held by the other.

Although direct acquisition of insurance companies has been restricted, this has not prevented the commercial banks from offering insurance services to their customers, and all the major banks have insurance brokering subsidiaries that advise and arrange business through the retail branch network.

Banks and building societies

As discussed earlier, the main competition that commercial banks have faced in recent years in the domestic market has been from the building societies. These mutual companies, many of which are still regionally based, take funds mainly through their retail branch network and specialize in domestic mortgage finance. Indeed, the legislation governing building societies has hitherto been particularly restrictive. The range of assets in which they could invest has been narrow and their lending had been confined to secured lending against residential mortgages.

New legislation in 1986, however, has allowed the building societies to widen the scope of their activities. In particular, they are allowed to compete with banks for unsecured personal lending and to have limited access to the wholesale interbank market for funding.

The banks responded to the competition from the building societies in a number of ways. Six-day opening, which had been abandoned in 1968, was reintroduced in major shopping center sites. There was a marked effort to improve the image of the banks with the public. Branches were refitted, interviewing areas were opened up in the public areas of banking halls, and a general effort was made to make banks seem more approachable and friendlier places to do business. Banks also began to compete with building societies in the mortgage market itself. Their motives were partly to stem the switch of retail business from the commercial banks to the building societies, but more importantly because it was seen as a way of improving the asset quality of the banks. In the United Kingdom, and other countries in Europe, residential mortgages have thus far proved to be very high-quality assets with extremely low default rates. Transition by the clearing banks into this market was not entirely smooth. The funds initially allocated were insufficient and customer demand exceeded supply. The banks were criticized for being half-hearted in their commitment to providing mortgage finance. These initial problems have now been resolved, with the mortgage market generally moving onto a competitive market-clearing basis. Pressure on capital ratios, however, has now led both the banks and building societies to look at ways of "securitizing" mortgage-backed assets by transferring them off balance sheet to specially established finance vehicles.

One of the clearing banks (Lloyds Bank) has also bought into a series of estate agencies, to produce a nationwide chain. Thus, it is able to offer a complete service to customers—finding the right house, financing its purchase, insuring the house, and if necessary, arranging life insurance for the borrower. The domestic property market has also been seen by others as a route into the retail market and, in particular, a way of marketing other financial services to high net worth individuals. Both a major insurance company (Prudential) and a merchant banking group (Hambros) have bought up individual estate agents to develop an extensive network marketing their services under the corporate name.

The U.K. securities market

Until the events known as Big Bang, specialization of functions had also been a characteristic of the United Kingdom domestic securities market. Stock exchanges developed in this country largely in response to the need of joint stock companies to share the load of raising capital for new enterprise in the 19th century. There were local stock exchanges all over the country, each with its flavor of local industry. All the stock exchanges of Great Britain and Northern Ireland were amalgamated into a single stock exchange in 1973, enabling the stock exchange authorities to impose common standards of regulation, enforcement, and discipline. The London Stock Exchange naturally dominated all these developments because it was to London that savings gravitated, London was the location of government, that great consumer of private savings, and London was the center through which investment was channelled overseas.

Access to the stock exchanges was restricted to members who formed themselves into partnerships. Incorporation was not permitted until 1969 and then only 10 percent of a firm's capital could be owned by a single nonmember. This was increased to 29.9 percent in 1982, but it was not until the changes associated with Big Bang that 100 percent outside ownership by a single nonmember was permitted.

Under the impact of heavy personal taxation that prevailed from the end of World War II until the burden began to be lifted from 1979 onwards, stock exchange firms became increasingly undercapitalized. This tendency was fostered by what was known as "single capacity", the rule that members of the exchange must either be brokers, acting as agents for their customers but taking no position as principals, or jobbers, making markets in stock but only able to deal with brokers. This system was undoubtedly good for investor protection, but it made it hard for U.K. stock exchange firms to compete with much better capitalized foreign securities houses as the securities markets became more international, or for them to satisfy the demands of the institutional investors that came increasingly to dominate the market.

Two further features of the stock exchange rulebook hindered its growth and development: minimum commissions set by the stock exchange itself, which were thought to be essential for the maintenance of single capacity, and limitations on membership which excluded foreign and corporate membership. The stock exchange was long able to satisfy the requirements of British industry and British investors, and its rules ensured that it was honest and ethical. But they left it ill-adapted to cope with internationalization of capital markets: the development of the Eurobond market in London almost completely bypassed the London Stock Exchange. No doubt this insularity was to an important extent encouraged by the existence of exchange control, which limited the horizon of U.K. investors. Certainly the large savings surplus associated with North Sea oil and the related abolition of exchange control in 1979 brutally exposed the limitations of the stock exchange, as the business arising from the portfolio diversification that ensued in large part went to overseas intermediaries in the country of investment rather than being routed through London brokers. This was chiefly because British stockbrokers had concentrated on the secure domestic market and had not sought or achieved analytic or dealing skills in overseas securities. And at least in comparison with U.S. markets, the London Stock Exchange was technologically backward.

It was the submission of the stock exchange rulebook to the Office of Fair Trading under the Restrictive Trade Practices legislation that was the catalyst for the changes that have transformed the face of the domestic securities markets. In order to avoid the delays and the inhibition to change involved in fighting a case before the

Restrictive Trade Practices Court, the stock exchange authorities agreed with the government to abolish fixed minimum commissions and to include lay members in their council. In the event, the changes went considerably further. Single capacity gave way to dual capacity so that the broker/jobber distinction disappeared, 100 percent outside ownership of member firms by other financial institutions was permitted, and a new market structure was introduced using screens for dissemination of market markets' quotes.

The consequences have been far-reaching, both in institutional terms and as regards trading structures. Nearly 20 percent of current member firms of the stock exchange are now foreign owned and the proportion of large firms that are foreign owned is much higher. U.K. banks, both clearers and merchant banks, have established powerful groupings combining stock exchange membership and market making. In sum, there has been a substantial increase in capital employed in position-taking and brokerage. The method of trading has also been radically transformed with the system being broadly comparable with that of the NASD in the United States (NASDAQ). Traditionally, the London Stock Exchange had enjoyed floor trading among competing market makers for domestic purposes. The Eurosecurities market that developed in London during the 1960s and 1970s was largely outside the stock exchange and was a telephone and screen market among competing dealers. With the new technology introduced into the stock exchange in the context of Big Bang, it was expected that the trading floor would decline in importance and that a considerable amount of business would be conducted from dealing rooms through telephones and screens. It was not expected that within a few weeks of Big Bang two-thirds of the equities transactions would be conducted away from the exchange floor and that now, nine months on, the floor would be virtually deserted.

As foreseen, the market for equities in London has become more efficient and competitive. The value of transactions has more than doubled since Big Bang—in response to lower transaction costs and increased information available to investors, which enables them to arbitrage more effectively. The enhanced liquidity of the market has mainly involved the most actively traded shares, but shares in smaller firms have benefited also. Spreads between best bid and offer prices have narrowed, and the transactions costs paid by institutional investors have fallen on major stocks from around 2.5 percent to 1.5

percent, in part because of a cut in stamp duty from 1 percent to 0.5 percent. In addition, an ability to deal on a net basis with principals—over 50 percent of deals are now conducted on this basis—thereby avoiding brokers' commission altogether, can reduce the transaction costs even further—to under 1 percent in some instances. The increase in turnover in equities has also been affected by the coincidence of another government policy, privatization.

Big Bang was not only designed to improve the market in U.K. stocks and shares. It was also aimed at capturing for London a significant share of the trading in equities that are internationally traded, which has been one of the most recent developments in the general internationalization of capital markets and has followed logically from the success of the international bond market. There are, of course, important differences between equity shares and bonds that are likely to prevent the development of an offshore equity market like that in international bonds. Investors need more protection regarding equities because the return is dependent upon the performance of the company and disclosure requirements are more crucial. There is also scope for insider trading. However, a domestic market can provide the right environment for trading of foreign equities. Shares in foreign companies have long been listed and traded in the United Kingdom—the shares of nearly 500 foreign companies from 38 countries are listed on the stock exchange. Changes in technology in the London market for international equities predate those in the domestic market. The London Stock Exchange developed a screen-based market in international equities some 18 months before Big Bang. This new market has been very successful, with at present 43 market makers, dealing in leading equities from about a dozen countries.

Another important area of the securities market that has undergone total transformation is the U.K. government bond or gilt-edged market, which is of particular concern to the Bank of England. In order to accommodate the move to dual capacity it became necessary to restructure this market rather on the lines of the U.S. Treasuries market. There are now 26 gilt-edged market makers (equivalent to primary dealers in the United States) and six interdealer brokers providing pricing information and anonymity in dealing between the market makers. Because of this market's importance to the authorities, the Bank of England acts as the supervisor of the prudential standing of the market makers and the interdealer brokers but the basis for all the changes in this market is nonstatutory. Here too, post-Big Bang experience has been encouraging. An already liquid market has become more liquid, with turnover now three to four times as large as before Big Bang. Dealing costs and price spreads have clearly fallen. Furthermore, the authorities have been able to embark on an experimental series of auctions to cover part of the government's funding requirements, supplementing the conventional tender/tap arrangements. Such an innovation is only possible because of the existence of a number of well-capitalized market makers in place of a few slimly-capitalized jobbers previously.

The restructuring of the securities markets has not all been plain sailing. There have been difficulties arising from the increase in the volume of trading in the U.K. equities markets. In so far as this related to some initial teething troubles with the new screen quotation system, matters were relatively easily rectified. The persistent difficulties firms' back offices and company registrars are having in keeping pace with the volume of business generated in a bull market in the new environment, with the added problem of coping with massive privatization issues, is more worrying. The stock exchange is addressing the problem with urgency, but experience in New York in the late 1960s and early 1970s and the difficulties being experienced in other European centers adapting to higher business volume shows that these problems are not easy to overcome. With the development of international trading in equities, settlement difficulties carry the risk of contagion between firms in different centers where there are delays in the transfer of securities that have been traded and, hence, of possible financial failure, quite apart from the risks inherent within a single center with settlement problems. They are also likely, unless cleared up fairly soon, to restrain the development of the international equity market.

In response to these settlement constraints, dealing costs to small investors, which had fallen less than those to institutional investors since Big Bang, have now risen back to the pre-Big Bang level and a number of firms are taking no new clients—at least temporarily. This is certainly an unwelcome development. By and large, however, the verdict must be that so far the main aims of Big Bang have been successfully achieved, although it is to be remembered that the systems have not yet been tested in a bear market.

Regulation of securities markets

The reverse side of the coin from the reorganization in the securities industry described above has been the construction of a new regulatory framework within which that industry should operate. The financial services industry in the United Kingdom had for many years been regulated by a limited and rather outdated statute, The Prevention of Fraud (Investments) Act 1958. This had been bolstered by varying degrees of self-regulation of some markets. This system is being replaced with a comprehensive regulatory system for investment business under the Financial Services Act. There has been some considerable misconception about the nature of regulation under this new legislation. The categories of statutory regulation and self-regulation and the well-rehearsed arguments for and against each style cannot be sensibly applied in the U.K. context. The new structure makes use of regulation by practitioners, but within a statutory-based system, although in one rather high profile area that is not subject to the Financial Services Act—the regulation of takeover and mergers activity—the Panel on Takeovers and Mergers does still operate on a wholly nonstatutory basis, subject, of course to the possibility of judicial review.

The Financial Services Act requires anyone engaging in investment business in the United Kingdom to have specific authorization to do so. The definition of investment business is drawn very wide, ranging from primary and secondary market activities in equities and debt instruments, the giving of investment advice on all investment instruments, the marketing and management of investment trusts and unit trusts, to the retail marketing of life insurance. The act gives powers to the Secretary of State for Trade and Industry, which he will delegate to the authority designated to regulate investment business in the United Kingdom, the Securities and Investments Board (SIB). The SIB will be financed entirely from the private sector by fees levied on those regulated. Firms will either have to be directly authorized by the SIB or will have to be a member of a Self-Regulatory Organization (SRO) recognized by the SIB. In order for the SIB to delegate its regulatory powers to an SRO, it must be satisfied that the regulatory scheme proposed is at least equivalent to that of the SIB. There are two main aspects to the regulatory schemes encapsulated in the SROs' rulebooks. The first concerns the financial soundness of the companies involved, including capital requirements for securities business. The second relates to the rules for conduct of business, covering such items as best execution of deals, conflicts of interest, etc.

The SIB received its authority from the Secretary of State for Trade and Industry last month and the five SR0's (the Association of Futures Brokers and Dealers; the Financial Intermediaries, Managers and Brokers Regulatory Association; the Investment Management Regulatory Organization; the Life Assurance and Unit Trust Regulatory Organization; and the Securities Association) are in the early stages of seeking recognition from the SIB. The SRO that will seem most familiar is that brought into existence by the merger of The Stock Exchange with the International Securities Regulatory Organization to form The Securities Association, which will cover most securities activities, including the Eurobond market in London. The intention is that the whole structure will be in place in the first half of 1988.

This regulatory scheme is somewhat unusual in having market participation as a fundamental precept. This is based on the principle that those closest to the market are better able to regulate the markets than a somewhat distant government department. It is recognized, however, that such a system could be open to abuse and it is for this reason that the SIB (which, while being practitioner based, is not self-regulatory) is, as it were, set in charge of independently overseeing the work of the SRO's. In this way, it is hoped to preserve the fine balance that there is in regulation not only between short-term market forces and the need for long-term stability and confidence but also between the political need to protect the small investor and at the same time meet the needs of the professional participants that bring the vigor and innovation on which markets thrive.

The new financial services legislation was triggered by concerns about small investors and, therefore, has relatively detailed rules aimed at protecting the small investor. It is in the wholesale money markets in sterling, foreign exchange, and bullion that the investor protection elements of the Financial Services Act seem, likely to be least appropriate. To recognize this fact, the government has provided an exemption for firms that come onto a list to be published by the Bank of England. Supervision of these firms' wholesale market activities will be on a nonstatutory basis, with their conduct being governed by codes of best market practice published by the bank. No firm will be compelled to come onto this list, but the bank considers it likely that most market makers and brokers will want to do so.

In admitting firms to its list, the Bank of England will take account of certain factors—in particular that the firm is adequately capitalized, has the relevant expertise to carry out its market making or broker function, and is of good reputation. Although there are some differences between the details of the capital adequacy tests proposed by the bank and those of the SIB, these are not expected to be significant in practice for most firms. More important, both the SIB and the Bank consider that their requirements will be broadly equivalent to those of the Securities and Exchange Commission in the United States, and intend to work towards the creation of a level playing field internationally.

Regulation of the banking sector

Turning to the regulation of the banking sector, the main changes took place with the initiation of a statutory based regime in the 1979 Banking Act. The 1987 Banking Act, which comes into force in October, mainly incorporates a number of amendments to the earlier regime that experience in the intervening eight years has suggested to be desirable and that were set out in the White Paper on Banking Supervision published in December 1985. The most significant changes are that, as mentioned above, the two-tier system of recognized banks and licensed deposit-takers is abolished and replaced by a single category of authorized institutions. The use of the name "bank" in a title is restricted for U.K.-incorporated authorized institutions to those with paid-up capital and/or reserves of more than five million pounds. Institutions are required by the statute to report to the Bank of England individual large loans and other exposures that are over 10 percent of their capital base and give prior notification of any proposed transaction which would exceed 25 percent of their capital base. The Bank of England's powers to obtain information from authorized institutions are enhanced, particularly as regards those that were recognized banks under the 1979 act. A discretionary power is given to Her Majesty's Treasury to direct the Bank of England to object to proposed controllers in U.K.-incorporated authorized institutions if the persons are connected with countries that do not give reciprocal access to U.K. entities in the fields of banking, insurance, and investment business. Authorized institutions are required to maintain adequate control systems and adequate accounting and other records, and auditors of authorized institutions are enabled to pass confidential information to the Bank of England, notwithstanding their general duty of confidentiality to their clients.

Another important evolution in the field of banking supervision, not confined to the United Kingdom, is the proposals on primary capital and capital adequacy assessment agreed between the U.S. federal banking supervisory authorities and the Bank of England and set out in a joint paper issued in January 1987. It is very much to be hoped that by the end of this year these proposals, amended as necessary, may have been generally agreed among all supervisory authorities of the G10 and European Community countries, thus establishing for the first time commonly accepted standards in this vital area. The evolution of international banking in a highly competitive environment has made harmonization and agreement between supervisory authorities on the fundamental supervisory concept of capital adequacy a high priority. Without it, there is a risk that a competitive rat race could be encouraged, which would not be conducive to the security of the international banking system.

Some regulatory problems

The patient reader will have observed that the separate evolutions of the banking system and securities industry in the United Kingdom described above have tended to bring them closer together and for the functions performed by institutions in each increasingly to merge. This has culminated in the creation at the time of Big Bang of significant financial conglomerates, combining under the same overall management a wide variety of financial operations (albeit often in different subsidiary companies) that had earlier been carried out in separately owned and managed entities. This functional evolution has followed the evolution of markets themselves, which have become more international, more integrated, and very much faster moving.

On the regulatory side, however, the functional basis of supervision has been deliberately maintained, notwithstanding the real possibility of supervisory overlap between regulatory agencies. This is potentially unsatisfactory and routes are having to be found to overcome these problems while still allowing individual regulatory agencies to fulfill their statutory responsibilities. Not only are there potential overlaps between one supervisory regime and another—for example between the Banking Act and the Financial Services Act—but also within regimes, such as between one SRO and another within the Financial Services Act. The most critical area of overlap is perhaps between banking and securities supervision when these activities are transacted within the same company. Both supervisors have statutory responsibility for the financial soundness of the company as a whole, and yet the rules being applied to determine that soundness may be different from one agency to another. In the case of banking and securities regulation there is a marked difference. Banking supervisors have a strict definition of capital, but a more flexible approach as to what counts as "adequate", in that they can tolerate short-term fluctuations from the target capital ratio set for an individual bank. Securities supervisors, on the other hand, have a strict capital requirement for a given portfolio of securities but a different definition of what constitutes capital from that of the banking supervisor. This, no doubt, reflects to some extent concern for the liquidity position of the securities houses, the volatility of a securities trading book compared with a banking book, and the greater precision with which position risks on portfolios of securities can be estimated from historical data.

The details of how supervisors will share their responsibilities are still being worked out. In principle, it has been decided that most banking companies caught within the Financial Services Act net will be subject to lead monitoring by the banking supervisors. The latter will confirm to the securities supervisors that the capital is adequate after taking into account the securities positions of the bank and will pass over to the securities supervisors any returns received that relate to securities business. It is also proposed that the banking supervisors notify the securities supervisors if the bank fails at any stage to meet its target ratios or if they decide to amend the target ratio, although the details of the revised ratio would not necessarily be discussed. The securities supervisor would have sole responsibility for compliance with the conduct of business rules. In principle, it is also possible that the banking supervisors may delegate lead monitoring of banks whose business is almost exclusively securities trading to the securities supervisor.

As far as complex financial groups are concerned, the United Kingdom has developed the concept of a "college" of supervisors. While individual subsidiaries would be subject to separate supervision by the appropriate regulator, it is seen as essential that supervisors should have the opportunity to discuss the activities of the group as a whole and to air any concerns with other supervisors. A group including banking and insurance supervisors, as well as the SIB, has been studying financial conglomerates and allocating them to a lead regulator who would chair the discussion of a particular financial group. At present, it has been relatively easy to determine which financial groups should come under the wing of which lead regulator. In other words, it is relatively easy to determine which groups are predominantly banks and which are predominantly securities traders. In the case of insurance companies, the policy of the banking and insurance supervisors, referred to above, has kept insurance companies and banks from combining with companies of similar size in each others' area. As with lead monitoring of individual companies, while outline arrangements for "colleges" have been agreed, the operational details have still to be resolved, but the Bank of England remains confident that with good will from all concerned, solutions to these complex problems can be found.

Conclusion: The future

The restructuring of the British financial system centered around Big Bang is still very recent, and the new supervisory regime is not yet fully in place so it would be tempting providence to speculate too far about possible further development. The ardent wish of many of those involved must be for a pause for breath, during which the new structures of markets and supervision can bed down into some sort of new equilibrium, but a great surge of competitive energy having been unleashed, a period of consolidation seems relatively unlikely. Experience shows us, of course, that human structures never are in equilibrium—every apparently static state has within it the seeds of its own change. The best one can do at this stage, perhaps, is to try to identify the main characteristics of those seeds, without seeking to forecast which will prove dominant.

The influences tending to push developments further in the direction in which they are already moving, i.e., towards further competitive restructuring of functions and the creation of new and larger financial service conglomerates, are still enormously powerful. International competition shows no signs of abating, particularly if judged against the volume of complaints that the playing fields are unlevel, and is likely to be given added impetus to the extent that pressures in the United States and Japan to amend the Glass-Steagall Act and Article 65 of the Japanese Securities Act prevail. There is no sign either that the major corporate customers for the improved and cheaper financial services being provided under the new structure are showing any tendency to move away from supermarket shopping to boutique shopping. We frequently hear from banks that in order to gain or retain major international companies as clients it is necessary for them to be in a position to offer a full range of products and services. Finally, the decisions taken at the political level by the countries of the European Community to liberalize capital movements and establish a free "internal market" in goods and services within the European Community by 1992 suggests that the scope for the establishment of genuinely European financial conglomerates could be enhanced. The competitive strength and capitalization of U.S. and Japanese securities houses in foreign markets is in no small part based on the size of their respective domestic markets. The creation of a genuinely free internal European market in financial services has the potential to provide a comparably strong domestic market to underpin the international activities of those European financial institutions with the imagination and will to exploit it, although it would be foolish to underestimate the political obstacles to be overcome.

There are, however, influences moving in the other direction. The adequacy of structures can only be determined when they have been tested in adverse conditions. So far, the restructuring of the British financial system has taken place in a sustained bull market. There are already signs, however, that some participants have decided that there is not enough profitable business to be done in certain areas, even in a reasonably benign market climate, to sustain the number of players currently competing for it. A few market makers have already withdrawn from particular markets. And concern is widely felt and expressed at the level of overheads, particularly in terms of remuneration packages that will have to be covered before profits will be seen. None of this is surprising in the context of the holistic changes that have taken place. By no means all firms wish to be all things to all men and by no means all who do are finding the going easy.

It is not only in new British financial conglomerates that the problems of control in large organizations have come to the fore, aggravated no doubt to some extent by the cultural differences to which reference has been made earlier. The measurement and control of risk is a difficult area for all firms operating in the current environment of financial innovation on an international scale, and there have been welcome signs in a number of areas recently that managements of financial institutions are **taking** this message to heart.

The danger of controls being inadequate in large organizations affects the attitude and conduct not only of management but also of supervisors. The larger and more varied the conglomerate, the more each functional supervisor must be concerned less a problem in one part of a conglomerate spreads by **contagion** to another. The instinct in such circumstances must be to err on the side of caution, which implies more supervision rather than less. There is a real danger that the costs of supervisory compliance may outweigh the potential gains of synergy from the formation of a conglomerate in the first place. Much will depend in the longer term on management systems to monitor and control risks being seen to be effectively implemented. The better the intemal management controls are seen to be, the less intrusive need be supervisory requirements. We shall hope to achieve the necessary stringency combined with adaptability at reasonable cost, by maintaining a pragmatic approach that remains so far as possible practitioner-based. Indeed the apparent complexity of the Financial Services Act derives in no small part from the attempt it represents to incorporate practitioner-based supervision. within a statutory framework. It is too early to say that the attempt will be successful.

Finally, it is hard to imagine any such success being lasting without the development of a harmonized approach to securities market regulation internationally. This has been the inevitable trend as regards banking supervision, slow and difficult as the process of harmonization has proved to be. It can hardly be otherwise **with** 'securities market regulation, and it is encouraging that the first steps are being taken in this direction.

Financial Restructuring: The Japanese Experience

Yoshio Suzuki

Factors leading to financial reform

The financial system of a country, regardless of time or place, is maintained to meet the economic conditions of that country. In the process of economic development, however, there occur new economic or technological conditions that foster change of the financial system: the coherence between the old financial system and the new conditions breaks down; internal inconsistencies develop; and the financial needs of the economy are not met sufficiently. In this situation, private financial institutions, which are rich in the spirit of creative tinkering, develop innovations even within the old financial system and circumvent old regulations in order to conform to the new conditions. There is, however, a limit to what such innovations can do, and eventually political and economic pressure develops for relaxation or abolition of all regulations. Meanwhile, the regulatory authorities have no choice but to ratify these private sector innovations through liberalization of regulations or restructuring of the regulatory framework. In this way, the driving forces of financial reform are the emergence of contradictions between the old financial system and the new technological or economic conditions and the reaction of both public and private sectors to these contradictions (Suzuki 1983a, 1984ab, 1986a, Silber 1983).

What then are the new technological and economic conditions that have driven the recent worldwide and simultaneous trend of financial reforms? There have been, in my opinion, four such conditions common to all countries. The first condition was the inflation that occurred worldwide after the first oil shock and the resulting sharp increases and volatility of interest rates. The second condition was the rapid progress of computer and telecommunications technology and its application in financial business. With this technology, financial institutions developed many of the so-called new financial products and significantly lowered the supply costs of financial services. The third condition was the more active international capital flows that occurred after the shift to the floating exchange rate system in 1973. The fourth and final condition was the expansion of fiscal deficits in various countries, which has tremendously expanded open markets in various countries because of the large-scale flotations of government bonds (Akhtar 1984, Suzuki 1984a).

Although financial reform is a phenomenon common to many countries, it did not necessarily manifest itself in the same way everywhere. In some countries, it was accompanied by disturbances such as bank insolvencies and bank runs, while in some countries there was intense pressure to change the permitted fields of business for financial institutions. Thus, it is difficult to describe simply the degree of financial reform in a country. If I may, however, make a bold attempt at classifying countries, they would fall into three categories: those that experienced sudden financial reforms, such as the United States and the United Kingdom; those that experienced gradual financial reforms, such as Japan and France; and those that experienced only limited reforms, such as Germany and Switzerland.

These differences in category may be attributed to two factors, the degree of regulation in the old financial system and the means by which the new conditions expressed themselves (Akhtar 1984, Bingham 1985, Suzuki-Yomo 1986). For example, in the financial system in the United States, there were, until very recently, strict interest rate regulations administered under Regulation *Q* and the regulations under the Glass-Steagall Act separating commercial banking from investment banking. In addition, there was the prohibition on carrying out banking business across state lines according to the McFadden Act, regulation not seen in other countries. Under this regulatory system, sudden, concentrated, and simultaneous changes in technological and economic conditions caused large fluctuations of both interest rates and prices in short periods of time and, thus, invited rapid financial reforms. In Japan, there also existed not only interest rate regulations and business activity regulations as in the United States, but also, until very recently, regulations that separated domestic and foreign markets. The new conditions in Japan, however, were primarily the large-scale flotation of government bonds and the growth in the movement of international capital flows, and they were felt over an extended period. Hence, there were no large fluctuations in interest rates and prices so that financial reform could proceed gradually. In Germany and Switzerland, interest rate decontrol had already been achieved in the 1960s and regulations on the business activities of banks did not exist in principle because of the approach of universal banking. Even with new conditions, the fluctuations of interest rates and prices were rather small so that financial reform proceeded only to a limited extent.

Looking to the future, one may expect that financial reform will be relatively rapid due to the development of information technology, even if other conditions are calm. This technological basis of financial reform has several implications. First is that such financial reform is unavoidable and irreversible; it will be quite difficult for the new system once formed to return to its original state. Second, such financial reform will proceed more easily. Since development of the computer software requires a great deal of know-how, time, and funding, it can lead to high founder's profits. Banking managers, thus, have a large incentive to develop new products. Third, such reforms will further globalize the financial system (BIS, 1986). Although the financial systems of each individual country grew in their own particular historical gardens, they must now adjust to the new, common, and worldwide soil.

Financial reform today and tomorrow: The Japanese experience

Financial reform in Japan first attracted attention when a new historical era emerged for the Japanese economy, the time of the Nixon shocks, the first oil shock, the end of the high-growth period, and the start of the floating exchange rate system. These developments faced the Japanese economy with a number of changes in technological and economic conditions.

The first major change was the large-scale flotations of government bonds that accompanied the shift to low growth and the consequent expansion of free-rate, broad, and open financial markets in both long and short-maturity assets. Developments included the secondary market in long-term government bonds, the primary market in medium-term government bonds, and the repurchase market. A second major change was the new sensitivity of corporations and individuals to free interest rates. This new sensitivity developed because of the need to cut costs in a period of lower growth, the lower rate of increase of wages, the strengthening of the own-capital base of corporations, and asset accumulation by individuals. The third major change was the integration of domestic and foreign financial markets after new incentives brought by the shift to floating exchange rates and the revision of the Foreign Exchange and Foreign Trade Control Law in 1980 that made capital transactions free in principle. The fourth major change was the active introduction of new telecommunications technology and computers by financial institutions, which improved efficiency of portfolio management and reduced costs (Suzuki-Yomo 1986, Cargill 1985).

With these four changes, the movement for financial reform began but soon conflicted with the financial regulations and customs of the postwar recovery period and high-growth period. The most important conflicts were in the areas of interest rate regulation, business activity regulation, and auxiliary regulations, such as those on capital flows, those on foreign exchange, and those aimed at maintaining orderly credit conditions such as collateral and entry regulations in banking.

Interest rate regulations

Because all but a very small portion of lending rates and bond rates in Japan are market-determined, the core of interest rate regulation is that on deposit rates. Such regulations were first introduced in the form of agreements among banks during the first third of this century, when there were repeated financial panics. These agreements were transformed into law in the postwar period in order to eliminate cartel behavior. Throughout Japan's high-growth period, the deposit interest rates were maintained in general at low levels. One cannot deny that this system intended to depress interest rates artificially in order to lower the financial costs of exports and investment (Suzuki, 1986a).

The influence of interest rate controls as a policy tool weakened with the onset of the lower-growth period, but the controls themselves remained. What weakened them so much were activities in the private sector that sought to circumvent the controls. First came the large increase in ***Gensaki*** transactions by securities companies from the mid-1970s. These transactions were generally of the same form as repurchase agreements (RP's) in the United States and transformed long-term (ten year) national bonds into a short-term (three to six month) free-rate securities. Corporations naturally shifted funds from regulated fixed-term deposits into the ***Gensaki*** market in order to invest their funds more efficiently. Next, the securities companies developed the medium-term bond fund, a type of investment trust for small unit transactions, and sold such funds to individual investors. In addition, the postal saving system, which is a type of publicly managed bank, developed an attractive asset known as the fixed-amount of postal savings account. This account became quite popular because of its high interest rate, and deposits shifted rapidly into such accounts. As a result of these innovations, the share of funds held by deposit taking institutions fell from the level of 60 to 70 percent in earlier years to about 40 percent. The banks countered these movements by the introduction of free-rate certificates of deposit (CD's) in 1979 and of money market certificates (MMC's) in 1985, whose interest rates were tied to CD rates (Cargill, 1985, 1986, Cargill-Garcia, 1982, 1985, Wenninger, 1984).

On seeing these movements in the private sector, the regulatory authorities not only approved the new financial instruments outside of the old regulatory framework but also liberalized the regulated interest rates that still existed. For example, in 1985, the interest rates on large-scale fixed-term deposits of more than 1 billion yen were liberalized, and thereafter, the minimum size for a free deposit was gradually reduced to 500 million yen, then to 300 million yen, then to 100 million yen. The denominations and minimum deposits for CD's and MMC's were also reduced, and currently the only deposits that face strict regulations as in earlier years are those of less than one month maturity and those of less than 10 million yen.

Although interest rate liberalization in Japan resembled that in the United States, there were differences in several important points. In the United States, the Depository Institutions Deregulation and

Monetary Control Act of 1980 was passed in March of that year and called for a policy of liberalization in the relatively short period of three years, so that liberalization would be accomplished by October 1983. In Japan, in contrast, since the announcement of liberalization in a Ministry of Finance report in May 1984, liberalization has proceeded gradually. Second, although both countries saw confrontations between banks and securities companies, there were also demands from savings banks and similar institutions in the United States, while there were demands from foreign financial institutions in Japan. Third, in the United States there has been a complete liberalization for small deposits, while in Japan there is still need for discussion on this issue (Suzuki, 1986b).

One of the great issues for Japan in the future will be how to promote the final liberalization of interest rates on small deposits. The government has made its policy on this quite clear:

> The liberalization of interest rates on small accounts will proceed after that on large accounts, and after promoting discussion at the earliest possible time of various specific problems on the basis of such factors as depositor protection, total balance between the postal savings system and other institutions, and other such background preparations.

On this basis, an advisory body to the Ministry of Finance has stated that "it is realistic to start liberalization with the establishment of small-scale MMC accounts as a transitional measure."

The difficulty is whether the introduction of small-scale MMC's can be followed by the complete liberalization of small deposit interest rates. This difficulty arises because of the postal savings system in Japan, an institution that does not even exist in the United States and that is much larger than the corresponding institutions in Europe. Because the postal savings system holds one-third of individuals' deposits, liberalization of all small deposit interest rates would make the postal system the price-leader. There is a fear that interest rates will be determined at levels that are quite different from those that would otherwise be determined by supply and demand.

Business activity regulations

There are three basic distinctions of business activity in financial markets in Japan: those between banking and securities businesses, between banking and trust businesses, and between long and short-term finance. Only Japan among the advanced countries has such a clear division of activities (Suzuki, 1986a). There have been several reasons for these clear divisions. The first was the recognition—based on the process of financial panics—that banks should specialize in short-term finance both to protect depositors and to avoid conflict of interest. The second was the need in the high-growth period for financial institutions that specialized in long-term finance, such as long-term credit banks and trust banks. The third, which applies particularly to the distinction between banks and securities companies, was the rather abrupt introduction in the postwar occupation period of the American system as a whole. There was also, however, a policy of using the specialization of securities companies to develop securities markets, which had been somewhat underdeveloped until that time (Bank of Japan, 1987).

Among the major countries, the system in the United States is closest to that of Japan, but even here there are contrasts, with Japan freer in some cases and stricter in others (Suzuki, 1986b). For example, the distinction between banking and securities businesses is not controlled in Japan through regulations on the acquisition of securities and equities with investment intent by banks, but the distinction is much,stricter in the United States and such acquisitions are prohibited. Joint operation of banking and trust businesses by banks is permitted rather freely in the United States, but not so in Japan.

The regulations on separation of business in Japan have been eased considerably in recent years. One area of easing concerns the distinction between banking and securities businesses. In the prewar period, tradition separated these two types of business with the exception of underwriting activities. In the postwar period, Article 65 of the Securities and Exchange Law regulated most activities, including underwriting. Under this article, as in the United States, the prohibition on bank securities business did not apply to national bonds, local government bonds, and government-guaranteed bonds, but administrative guidance in Japan, in fact, prevented underwriting all but national bonds.

But changes in conditions caused changes in the system. In the second half of the 1970s, with the large-scale flotations of national bonds, the banks wanted to supply new financial products that involved government bonds. This desire led to a major debate between the banking and securities industries, and in the end, the new Banking Law of 1981 and the revised Securities and Exchange Law settled the issue by clarifying the forms in which banks might carry out securities business activities.

Under the new law, banks were permitted for the first time to carry out subscription activities connected with the underwriting of public bonds and to deal in public bonds. Securities companies, on the other hand, were permitted to establish medium-term bond funds and to use these to develop Cash Management Accounts (CMA's) that are almost identical to those in the United States. Thus, the securities companies were successful in creating a high-yielding account with a payments facility, even though formally these payments go through an ordinary deposit account. Moreover, securities companies were permitted to make loans to their customers on the collateral of public bonds. Both banks and securities companies are operating in the new established bankers acceptance market and will also operate in the new commercial paper (CP) market that is expected to begin this fall.

The distinction between long-term and short-term finance is also growing weaker, as commercial banks expand long-term lending and as institutions that had specialized in long-term finance expand short-term lending. On the asset side, the regulations that separated long-term and short-term institutions are losing all meaning. On the liability side, however, the commercial banks remain restricted to deposits of less than two years in maturity, while the long-term credit banks are permitted to raise funds of up to five years in maturity. Thus, for the commercial banks, there is a mismatch of maturity structure, and they have handled this problem through measures to circumvent regulations, such as interest rate swaps. In the future, even liability side distinctions will gradually fade, as commercial banks may float long-term CD's in the Euromarkets or lobby to allow a lengthening of the maturity of their domestic fixed-term liabilities.

The distinction between commercial banks and trust companies is also weakening. For example, a major fund-raising method for the trust banks has heretofore been the so-called money loan trust, which matched long-term assets'and liabilities. However, as the barriers on the liability side between long and short-term finance are reduced, the distinction between money loan trusts and other types of long-term fixed-term deposits will blur. Moreover, in the area of pension trusts, which were the original type of business for trust banks, criticism of barriers to entry from both domestic and foreign sources has been growing because this is a growth area. The barriers here will have to be reduced over time.

The problem of barriers between commerce and banking was one focus of the Corrigan Report (Corrigan, 1987), but this particular problem is not very keen in Japan. The reasons for this are that financial holding companies are not permitted and that Japan has no interstate banking regulations that give incentives to establish nonbank banks. In addition, it is not easy for a bank to be taken over through stock purchases, because ownership of bank stock in Japan is very broad based due to the preference of stockholders for longer-term assets.

Nevertheless, it seems inevitable that sooner or later such problems will become important in Japan as well. When they do, as pointed out in the Corrigan Report, it will be necessary to classify financial institutions into several categories according to their payments activities, i.e., by listing the activities that may be carried out by financial institutions that have settlement facilities as part of their business. This is the right method for the distinction because the stability of the payments system is the most important basis of a financial system.

The Corrigan Report also proposes a National Electronic Payments Corporation to help stabilize the payments system. In Japan, heretofore, payments services have been provided by a cooperative system between the central bank and private sector banks. It would be necessary to consider carefully what effect the establishment of a third party in the middle would have on the payments system.

Auxiliary regulations for orderly credit conditions

The ex ante safety net for the payments mechanism in Japan has two major parts, bank supervision and portfolio regulations (e.g., capital adequacy, liquidity requirements, and loan concentration limits). The ex post safety net comprises the central bank's lender of last resort function and the deposit insurance system. These two safety nets do not differ in major respects from those in the United States or other major countries (Friesen, 1986). Japan does differ, however, in the financial customs for supporting orderly credit conditions and the actual administrative operation of the safety nets. The most important differences lie in such areas as collateralization of assets, the regulations on bank entry and exit, and the supervisory system of financial institutions.

Collateralization has long been the principle for financial transactions in Japan. Both issues of corporate debentures and interbank transactions have always been collateralized. Bank loans were mostly collateralized as well, but recently the proportion of collateralized loans has fallen precipitously because of increased foreign lending. Nevertheless, for city banks, 25 percent (and 60 percent if guarantees are included) of loans are collateralized.

The principle of collateralization, like other regulations, was based on the experience during financial panics and took hold spontaneously as a financial custom, but as the internationalization of finance progresses, customs such as this, which are unique to Japan, are increasingly being reconsidered. In the long-term bond market, the issue standards for noncollateralized bonds have been eased substantially, and as of April 1985, two rating companies had been established. In the money markets, at the behest of foreign banks, noncollateralized transactions were permitted in 1985. The new CP market will also be an uncollateralized market, and thereafter uncollateralized transactions in corporate bonds and other instruments are expected to increase substantially. For this to occur, however, it is urgent that the rating companies mature (Cargill, 1986, Suzuki, 1986b).

Japan has also differed from other countries in its attitude toward entry and exit in banking. Administrative guidance has enforced the basic principle that, with exception of the entry of foreign banks, neither establishment of new banks nor dissolution of existing ones is permitted. There has not been a single newly established domestic bank since the last half of the 1950s, with the special exceptions of changes of the corporate form of certain institutions. Neither has there been a single bank failure in the postwar period nor a drawing on the resources of the deposit insurance system since the system's inception in 1971. This contrasts with practice in the United States, where more than 300 banks were established and 138 disappeared last year.

Entry and exist practice in Japan is based on a number of factors, including historical experience and the need for efficiency. Japan's experience during the financial panics was that newly established banks went bankrupt easily. The number of banks in Japan fell from 1,036 in 1920 to 369 in 1940, but most of these were saved by provision of liquidity from the central bank, and in the end they were absorbed by other banks in the form of mergers. In the postwar period as well, whenever problem banks arose mergers were sought with other financial institutions so that there were, in fact, cases of disappearance of institutions. In contrast, in the United States in the period of financial panics, there were many bank failures one after another so that between 1920 and 1940 the number of banks was reduced from 30,291 to 14,361, most of which came through the straight out closing of banks. Such closings continued in the postwar period (Golembe-Holland, 1983, Kane, 1977, 1981). Whether this contrast will continue is an open question. As liberalization in Japanese financial markets continues, there has been a strengthening of bank management, and there was an expansion of the deposit insurance system last year. It is not clear, however, whether because of this expansion there will start to be bank failures in Japan.

The third difference between Japan and other countries is in elements of bank supervision. First, the right to issue operating permits belongs to the Ministry of Finance in Japan for all types of financial institutions, i.e., not only for banks but also for credit cooperatives, government-related financial institutions, securities companies, insurance companies, deposit insurance institution, etc. There is only one exception, the postal saving system, for which the supervision authority lies with the Ministry of Posts and Telecommunications (Hamada-Horiuchi, 1984, Horiuchi, 1984). In the United States, in contrast, the supervisory system is extremely complicated. Second, the Bank of Japan may carry out transactions with all types of financial institutions, so that there are regulations and supervision concerning matters related both to monetary policy and credit conditions for all institutions with which the Bank of Japan has business contracts. For example, the Bank of Japan is permitted to open current transaction accounts with securities companies and may also conclude lending transaction contracts, but as a result of these relationships, the securities companies are subject to the same supervision as banks. In contrast, in other major countries, the central banks in principle do not carry out transactions with securities companies, and regulation and supervision functions are carried out by other government institutions, such as the Securities and Exchange Commission in the United States. Third is the central function played by examinations of financial institutions. Both the Ministry of Finance and the Bank of Japan carry out on-site examination of banks every two years, and thus, each financial institution has an examination every year. This method was adopted because there are limits to the effectiveness of explicit regulations, such as capital adequacy. It is based on the idea that, in the final analysis, the only check on the soundness of management is an assessment of the assets of the institution at the micro-level. This method does, however, have the two demerits that it imposes a very heavy burden on the central bank and that it is difficult for depositors and investors to understand. In foreign countries, explicit regulations are used for the most part. In the United Kingdom and West Germany, on-site examination are not even performed. The systems of supervision are also undergoing reform as they seek to adapt to new conditions, such as implementation of electronic data processing supervision.

Future issues for Japan

Financial reform has already gone far in Japan and, given the effects of technological progress and other factors, seems likely to go farther. If it does, the major issue will be the stability of the resulting financial system.

The term "stability of the financial system" has various meanings, but two are of primary importance in Japan. First is stability in the sense of whether the new financial system in Japan will, in fact, be consistent with those in the rest of the world and thus be able to avoid further revision—given that this new financial system will be constructed along lines that answer the realities of the Japanese economy. Consistency is particularly important for Japan today, as Japan constitutes one-tenth of the world economy and is the largest creditor on earth. Second is stability in the sense of whether the new financial system will be able to perform the major functions of the old financial system, such as intermediation, risk-avoidance, and payments. As pointed out in the Corrigan Report, the most important is stability of the payments system. This importance is due to the fact that the payment system is the basis of the society and the economy and is the fundamental function of the financial system. Two aspects of this problem are of interest in light of Japanese conditions, the internationalization of regulation and ensuring stability of the payments system.

Internationalization of regulations

Although the globalization of financial markets has become possible because of the easing of regulations, there has also been an inverse effect. If one were to stress domestic stability too much and resist all pressure toward change, then international stability would be sacrificed and, ironically, the system would become unstable.

One related issue is how to respond to the competition of systems that results from the competition among national markets. In a globalized situation, both financial institutions and corporations may freely choose among systems and markets to make their transactions, so that when one country's regulations are less convenient than another's, financial transactions will leave the country with the inconvenient regulations. In this process, markets in the convenient countries will wax, and those in the less convenient countries will wane. This phenomenon, the so-called "hollowing out of financial industry," may be seen to an extent in various countries as they changed regulations in an effort to gain business for the financial institutions and the financial markets of their own countries. This motivation was seen very strongly in the recent opening of offshore markets in various countries and in the Big Bang in London. In Japan as well, the Tokyo Offshore Market was established at the end of last year, although in this case the establishment was more the result of demands from abroad.

Financial reform from an international point of view is, therefore, necessary, but there are many points of substance to consider. One of these is the ease with which there might emerge excesses in the competition between the systems in various countries. Precisely because the regulation and supervision of banks in offshore markets is weaker than that in domestic markets, there is a need for caution about the consequences of this competition. For this reason, the Bank of Japan has been emphasizing for some time the need for joint progress in the offshore markets and domestic liberalization.

Another regulatory problem brought by globalization is the issue of the so-called "level playing field" that accompanies the intensification of competition among market participants. This is the reaction to the competition of systems not by changing the system in one's home country to the more attractive state of another but by trying to change the regulations in other countries with a view to offsetting disadvantages of one's home financial institutions or markets. For many years, there has been a principle among the major countries of national treatment in matters relating to the entry of foreign banks into a country and in the matter of regulation on domestic activities. But as globalization progresses and as the competition among the world's financial institutions becomes more severe, contrary trends have emerged. One of these trends is toward pressure on other countries to ensure that they are faithful to the promise of giving national treatment. Another is the use of so-called reciprocity in financial activities. A third is toward extraterritorial application of the regulations of one's home country for certain types of financial transactions. All these methods are forcing an internationalization of systems, for better or for worse.

When the topic turns to the level playing field among many countries in a globalized situation, the issue then becomes one of standardization of regulations across countries through multifaceted discussions and international agreements among the public authorities of the various countries. For example, the United States and the United Kingdom developed a joint standard for capital adequacy for banks early this year and then called on Japan and other countries to agree to these regulations. Japan would be willing to agree to this on the condition that the definition of bank capital recognize certain customs concerning the treatment of the difference between the market value and the book value of securities held by banks. That is, it has been a custom in Japan to cover losses not by reductions in capital but by liquidation of equities. The difference between the market value and the book value of these equities is applied to cover losses. If the unrealized profits on the holdings of securities at book value were to an extent recognized as capital, then Japan would accede to the international movement. In fact, Japanese authorities currently recognize 70 percent of the latent value of securities in their calculations of the capital ratios of financial institutions. On this basis, the capital ratios for city banks lie in the range of 8 to 10 percent, although the ratio would fall to about 3 percent if these unrealized profits were excluded.

This level playing field issue is also related to the differences between various nations' systems in the treatment of collateral requirements and separation of types of business activities. In Japan, it is generally the case, as mentioned above, the banks have either collateral or guarantee for lending, and also as mentioned above, there are differences relating to purchase of equities by banks and joint management by a bank of both trust and commercial banking activities. In order to standardize regulations, there will have to be deepening of mutual understanding of the financial systems among countries so that the various sides can meet in the middle.

Ensuring stability of the payments system

Financial reform has also brought major changes to the payments system, and one of the major concerns is increased systemic risk among banks (Corrigan, 1982, Stevens, 1984).

Systemic risk is now greater because of the various types of basic risk that have accompanied liberalization of finance, such as interest rate risk, liquidity risk, credit risk, and foreign exchange risk. On the whole, the possibility of insolvency of some participant in the payments system has risen. The development of electronic funds transfer and of international payments systems has multiplied the quantities of funds being settled, and thus the possibility of an accident has increased (Vergari and Shue, 1986). At a more fundamental level, there has been a shift of the means of payment from bank notes that are supplied by central banks to checks, credit cards, and preauthorized direct debits that are supplied by private financial institutions. The consequence of this shift has been a diminution of the "finality" that bank notes bring to the payment system and an increase in the accumulation of arrears.

In order to avoid systemic risk, several policies may be adopted. For example, in the United States there is a cap policy. Such a method of dealing with the problem cannot, however, go beyond certain limits. A more fundamental approach is the reduction of arrears through recovery of finality in payments. The reason bank notes with their finality have been losing ground to private sector concentrated payments mechanisms is that these mechanisms are more efficient. If, however, technological progress lowers the cost of settlement on a one-to-one basis, then there will be no need to raise dependence on the private payments mechanisms to the point of ignoring the enlarged risks.

There are several types of payment mechanisms currently in use in the United States that have finality and, indeed, may be called "convenient electronic bank notes." Examples include the use of federal securities on other transactions that use Fedwire or deposits at Federal Reserve banks. In Japan as well, there is a clear social need for such convenient electronic bank notes and a need for both the Bank of Japan and private sector financial institutions to answer this need. The settlement system with federal securities over Fedwire in the United States also involves simultaneous delivery of the securities and execution of the settlement of funds in the form of delivery against payment. Neither securities settlement system in Japan has this form. From the view point of reducing risk, the necessity of introducing such a system is growing.

The traditional notion of a safety net is also important in the effort to reduce the latent risks in the payments system. To ignore it would be to increase the burden on existing safety nets and would lead to fears of greater burdens on banks—because of the need for higher payments reserves, higher capital, and higher deposit insurance rates.

The ex ante safety net must, of course, be based on sound management, self responsibility, and increased supervision and examination. In the ex post safety net, the central bank would form the nucleus as lender of last resort. The net would also be supported by the deposit insurance system. It is ne'cessary to remember, however, that too much reliance on ex post mechanisms will raise moral hazard and perhaps ironically lead to a reduction in the soundness of the system (Benston, 1986, Kaufman, 1986). In maintaining orderly credit conditions, the ex ante elements of the framework must function sufficiently, but the ex post mechanisms must also act appropriately. Only in this fashion can the stability of the payments system be maintained through the complimentary actions of both.

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Perspectives on Financial Restructuring

L. William Seidman

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

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

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

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

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

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

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

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

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

When I was confirmed as chairman of the FDIC some 20 months ago, I had one advantage. As a newcomer I did not have any fixed perspective on how a financial restructuring should be accomplished and, as I have said, I did not think about it much. Thus, it seemed useful to try to get together an organized and objective inventory of just what was on the table and find out what tools were available, drawing both from historical mandates and current options. Let me summarize then, our FDIC study.

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

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

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

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

The study then proceeds to deal with the prohibitions set forth in the Glass-Steagall Act. It concludes that, in the 1930s, the general view of Congress was that the mixing of commercial and investment banking threatened the safety and soundness of the banking system, created numerous conflict-of-interest situations, and led to economic instability. To alleviate these concerns, the Glass-Steagall Act was enacted. It appears that, to the extent that these concerns were valid, they could have been handled through less disruptive means. But abuses did occur. The study concludes that with a degree of supervision and regulation and some restrictions on bank affiliate powers, significant progress could have been made to correct the failures that occurred without the stringent measures of Glass-Steagall. Glass-Steagall was not the required answer.

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

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

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

The opinion of the FDIC's corps of professional bank supervisory personnel, speaking from experience gained in thousands of bank examinations over a 54-year period, is that a "wall" is indeed "do-able." Furthermore, this "wall" could be constructed in a simple, practical, and effective way. Also, it should be possible to determine what activities can occur either outside or inside the wall.

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

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

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

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

FDIC's bank supervisors, speaking from 54 years of examination experience, believe that these materials will be sufficient to construct a workable "wall." The view of our supervisors is that out of the 10 percent of bankers who, ***in theory, might*** be prone to abuse the new rules, that these tools would be enough to catch at least nine out of ten of the abusers. It would also mean for the vast majority of bankers a better shot than they have now for improving their competitive positions, and as well as the capital, and safety, of their institutions.

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

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

We do not need to set an unchangeable course. We can move in a step-by-step process toward a less regulated structure, with an evaluation of each step along the way. The suggested step-by-step process is outlined in Chapter 9 of the FDIC study. However, if we can agree upon the fundamentals, we will know where our steps are leading us. We are headed toward a system that keeps banks safe because they are special but lets the marketplace around them operate with freedom from bank regulators. This can create a safer and sounder system for depositors, users of the transfer system, borrowers and traders; a more competitive and better capitalized banking system, a simpler and less costly regulatory structure, and a system that can serve consumers more efficiently. It also assures that the Federal Reserve has its needed tools for monetary control.

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

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

Executive Summary*

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

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

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

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

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

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

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

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

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

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

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

The law has always permitted individuals to own controlling interests in both a bank and a commercial firm. During most of our history, nonbanking firms also have been allowed to own some form of a bank. It is only since the passage of the Glass-Steagall Act in 1933 that affiliations between commercial banks and securities firms have been restricted. Other affiliations between banks and nonbanking firms continued uninterrupted until 1956 when the Bank Holding Company Act became law. Even today, some commercial firms own banks.

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

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

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

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

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

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

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

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

The focus of Chapter 6 is to determine if there should be restrictions on the activities of banking organizations due to the need to protect the safety and soundness of the banking system.

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

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

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

Can banks be insulated effectively from the risks posed by new activities? The conclusion of Chapter 6 is that effective insulation is possible if new activities are placed in subsidiaries or affiliates of the bank. Subsidiaries and affiliates can be protected against legal risks if certain procedures are followed to ensure that the operations are conducted in truly separate corporate entities. While there are economic incentives to treat different units as part of an integrated entity, these can be controlled largely through existing legislation such as Sections 23A and 23B of the Federal Reserve Act and proper supervision of the bank itself, with appropriate penalties for abuses. The marketplace will view different units within an organization as distinct corporate entities if they are, in fact, treated accordingly by the supervisory agencies. There is growing evidence that as bank supervisors make distinctions between banks and their holding companies and affiliates, the market will do the same.

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

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

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

On balance, it is unclear whether banks possess a competitive advantage over nonbank firms. Regardless, equity can be obtained by allowing the same options to all. As banks are allowed to engage in nonbanking activities, nonbanks should be allowed into banking on the same terms as other banks. Given equal options available to all, there need be no concern about competitive equity.

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

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

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

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

Finally, safety-and-soundness concerns need not be exacerbated by the development of a banking industry with fewer and larger entities than at present. A major reason why banks may grow larger is to take advantage of diversification opportunities, which should strengthen banks. Moreover, as the number of banks decline, there will be fewer opportunities for banks to slip through the cracks and avoid governmental supervision that can detect unhealthy behavior. Although there is not sufficient evidence to conclude that undue concentrations will arise if banking and commerce are allowed to mix, these concerns deserve careful consideration by Congress.

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

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

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

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

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

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

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

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

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

This restructuring would be accompanied by a strengthening of the supervisory and regulatory restrictions on banks.'The prudent supervision of banks would become more important, along with the need to monitor and limit risks posed by new activities conducted in the bank.

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

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, andinsurance—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 nonthrift 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 insurarice, 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.

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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 modem 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.

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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-Stegall 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
Technigue	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 holdrng 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 "over-sight" over financial services holding companies, and enforce supplemental insulation provisions and affiliation restrrctrons.

6 The Federal Reserve would supervise intermedrate 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 nonbank 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-Stegall 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 secbon, 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 conbnue 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 affdiation, 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.'

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 consolldated 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 transaction's 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 nonbank 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.

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[9] For example, the quantitative restrictions in Section 23A suggested by the Associabon 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 nonbank 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

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[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.

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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 appropnate 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 unproper 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.

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The Case for Preserving Regulatory Distinctions

James Tobin

The structure of the monetary, banking, and financial institutions of the United States is currently a topic of unusual excitement and controversy. Divers reforms have been proposed, some in legislative form. No consensus has been reached, and at present there appears to be a political stalemate. Meanwhile, the structure is changing in a piecemeal and anarchic fashion, as a result of technological and institutional innovations, private initiatives, accidental quirks of ancient laws, administrative and judicial decisions, and actions by various states. As recent events attest again, Congress cannot agree on basic solutions and tries halfheartedly to arrest the disorderly drift.

Two sets of issues are before the Congress, the Executive, the courts, and the country. One concerns the range of activities permitted to various types of financial and nonfinancial enterprises and their affiliates or subsidiaries. Should banks and other depositories, or their holding companies, be allowed to engage in various businesses from which they are now excluded—underwriting and other investment banking activities, insurance, real estate, and other non-monetary and even nonfinancial transactions? Should other private enterprises, financial and nonfinancial, be allowed to engage in commercial banking and/or to accept insured deposits, either directly or through affiliates or subsidiaries? Issues of this type touch conflicting private interests and privileges, the principal stuff of politics. Consequently, they are the focus of attention in the affected industries, in the media, and in legislative debate.

Nevertheless, I think the second set of issues is the more crucial and deserves priority. I refer to the structure of the monetary, banking, and depository system itself. We need to protect the system of monetary payments, assure the availability of safe and convenient media of exchange and other assets to the general public, preserve effective macroeconomic monetary control by the Federal Reserve System, and maintain the sovereign power and responsibility of the federal government, under the Constitution, to "coin money and regulate the value thereof."

The deposit insurance systems, on which we have relied heavily for a half century, no longer appear adequate to achieve these basic objectives. There is danger that these basic problems will be neglected or subordinated to the politically charged issues of the first set. To me, it makes more sense to settle on a viable monetary and depository system for the future ***prior*** to deciding what activities members of that system should be allowed to engage in and what monetary and depository activities other private institutions should be permitted,.

For these reasons, I shall take up the second set of issues first.

Federal safety nets and moral hazard

Can large financial enterprises be allowed to fail?

Depository institutions, banks and thrifts, have been failing in numbers alarming to a public accustomed to thinking that failures were a Depression problem solved by New Deal legislation in ancient times. By the same token, the spectres of bank runs, financial collapse, and depression itself haunt regulators, legislators, and other policymakers. They have used powers and instruments unavailable to their predecessors in the 1920s and early 1930s to control and contain the damage, quite successfully to date.

Large banks and their depositors have been virtually guaranteed rescue, by giant loans "of last resort" and by de facto extension of deposit insurance to 100 percent coverage. This was the precedent set by the Continental Illinois case. Although management and stockholders did not escape unscathed, the ability to shift risk to the federal government is bound to tempt depositors and managers to take more risk.

The memory of the Depression was a big reason for the policy of rescue, but in my opinion not a good reason. The analogy is misplaced. Bank runs in the Depression were an economywide catastrophe because they became a general run of depositors to currency. The banking system was drained of reserves, and the Federal Reserve was unable or unwilling—it is not necessary here to enter the debate which—to expand the supply of base money enough to offset the drain. Shift from bank money requiring only fractional reserves to 100 percent currency money cut down the total money supply—that is the monetarist way to look at it—and reduced the supply of loanable funds from banks—that is the eclectic way to put it.

In the 1980s runs to currency are not the problem. The deposit shifts we have seen have been from threatened institutions or particular types of institutions in particular jurisdictions to similar deposits elsewhere. Such shifts do not destroy bank reserves in aggregate. Indeed, central bank lending to the reserve-losers—recall that Federal Reserve loans to Continental Illinois were $6 to $7 billion, compared with normal aggregate borrowing at the discount window of $1 billion or less—actually increased total reserves. To maintain a stable overall monetary stance, the Federal Reserve had to remove a roughly equal amount by open market sales.

Should there be a run to currency, rather than from one bank to another, today's Federal Reserve would not be deterred by the obstacles that prevented the Federal Reserve of the early 1930s from supplying the currency. Federal Reserve banks are no longer required to hold gold or other specified assets as backing. They can lend to depositories and buy paper in the open market without limit. Unlike their predecessors, they would presumably be free of doctrinal, political, and psychological inhibitions against such actions.

In the early 1930s, we were still on the gold standard, and a run to foreign currency or gold panicked U.S. authorities. Thanks to floating exchange rates, their successors are spared this anxiety. They may not, of course, welcome a decline in the market value of the dollar, but the trauma is a lower order of magnitude.

For these reasons, I see no convincing macroeconomic reason for the U.S. government to guarantee that a large depository will not be allowed to fail. Without doubt, there would be turmoil in financial markets for a few days on news of such a failure, but such frenzies have few consequences for the vast economy and population engaged in producing goods and services. I observe that the financial markets have taken in stride large banks' recognition of losses on their foreign loans.

Of course, the prospective failure of any large company, nonfinancial or financial, generates strong economic and political pressures for government rescue. Even some economists and policymakers who are generally suspicious of the arguments used in such cases find special reasons for bailing out large financial enterprises. Given the proclivity of the monetary and financial regulators for averting failures of large depositories, proposals to restructure the financial system should guard against changes that make rescues even more compelling.

The system of depositories is drifting toward oligopoly of giant nationwide banks and bank holding companies, and to conglomerates engaged in a host of financial and nonfinancial businesses. An unfortunate byproduct of this drift would be that the government would be so fearful of the consequences of a failure of these giants that their survival would be guaranteed—whatever the nature of their difficulties, whether they presented any threat to the payments system or not, indeed whether they were connected to financial or nonfinancial activities.

The abuse of deposit insurance

The truly urgent problem, I think, is the abuse of deposit insurance. Ironically, it was the innovation of deposit insurance in 1935 that is credited for the avoidance of epidemic runs from banks ever since.

Deposit insurance is a delegation to private enterprises of the government's sovereign right to coin money. The government promises to coin money to meet the depository's promises to its creditors in case it is unable to redeem them itself.

For the contagious runs to currency 55 or 60 years ago, deposit insurance, financed by uniform premiums, made sense. Confidence in the system was a public good to which all institutions, whatever their individual balance sheets, could be expected to contribute. Of course, some institutions were insolvent because of bad loans and investments, but it was possible to argue that these were largely macroeconomic and stochastic in origin.

Today, however, there appears to be a much greater component of imprudence and adventurism, even self-dealing, in the incidence of failure. Moral hazard is rampant; The sounder and luckier—it is not easy to distinguish—members of federal insurance corporations understandably balk at paying higher premiums to salvage the depositors of failed members. The taxpayers can be left holding the bag. Congress affirmed the government's ultimate guarantee just the other day.

As has long been recognized, deposit insurance dulls the incentives of depositors to scrutinize the soundness of the depository's assets and the incentives of the institution itself to maintain liquidity and asset quality sufficient to limit to low probability the contingency that it will be unable to meet withdrawals.

These dilutions, it seems, began to be a serious problem when interest on insured deposits was deregulated, even to the extent that deposits effectively payable or transferable on demand became interest-bearing. The history is revealing. Interest prohibitions and ceilings were legislated in the 1930s, mainly because of the perception that previously deposit interest competition had contributed to bank failures. The argument was that banks had to reach out for high return but unsafe loans and investments in order to pay competitive deposit interest rates. In the postwar debate about the regulation of deposit interest, that argument was discredited on both theoretical and empirical grounds. Anyway, it was alleged, deposit insurance by itself had motivated the 1930s legislation, so that interest regulation was redundant.

However, the combination of unregulated deposit interest and deposit insurance does enable depositories to attract deposits to finance adventurous and even corrupt asset management, as the recent examples of Texas thrift institutions dramatically illustrate. Depositors who enjoyed high certificate of deposit (CD) rates are kept whole at the expense of those of other institutions whose deposit insurance premiums pay them off or of general taxpayers.

A minor reform would mitigate the attraction of above-market interest rates to finance unsound loans and investments. This would be to subtract from the amount of a depositor's balance, in reckoning the amount insured, the excess of all interest credited or paid in excess of some standard rate, the Treasury bill rate or the Federal Reserve discount rate.

A remedial proposal that comes naturally to economists is to scale premiums to risk, just as auto insurance premiums vary with the risk categories of drivers. However, it does not seem possible to gauge the riskiness of asset portfolios in advance, and basing them on "accident" experience is too late. For similar reasons, surveillance by examiners is not wholly effective.

"Deposited currency"

I believe, therefore, that the monetary and depository system should be restructured to reduce the reliance now placed on deposit insurance to protect the monetary payments system. I have two proposals. One is to provide a kind of deposit money so safe that it does not have to be insured. The second is to make in advance a sharp distinction between insured and uninsured liabilities, and to stick to it. This involves separating "commercial banks," which accept insured deposits, from "investment banks," which do not.

To diminish the reliance of the payments system on deposit insurance, I have proposed making available to the public what I call "deposited currency." Currency—today virtually exclusively Federal Reserve notes—and coin are the basic money and legal tender of the United States. They are generally acceptable in transactions without question. But they have obvious inconveniences—insecurity against loss or theft, indivisibilties of denomination—that limit their use except in small transactions (or in illegal or tax-evading transactions.) These disadvantages, along with zero nominal interest, lead to the substitution of bank deposits for currency. But deposits suffer from their own insecurity, unless guaranteed by the government; and the guarantees of deposit insurance are subject to the abuses discussed above.

I think the government should make available to the public a medium with the convenience of deposits and the safety of currency, essentially currency on deposit, transferable in any amount by check or other order. This could be done in one or more or the following ways:

(a) The Federal Reserve banks themselves could offer such deposits, a species of "Federal Funds." Presumably they would establish conveniently located agencies in private banks or post offices. The Federal Reserve banks would pay for the services of the agents. Potential agents could bid for the contracts. Transactions between holders of deposited currency accounts, or between them and, directly or indirectly, other Federal Funds accounts would be cleared through the Federal Reserve. Wire transfers, as well as checks, would be possible. Giro-type payment orders to other accounts in the system could be made. Overdrafts would not be allowed. Computer capabilities should soon make it possible to withdraw conventional currency at any office or agency, and even to order payments to third parties by card or telephone. Interest at a rate sufficiently below the rates on Treasury securities to cover costs could be paid, and some costs could be charged to accountholders.

(b) Banks and other depository institutions could offer the same type of account, or indeed be required to do so. The deposited funds would be segregated from the other liabilities of the institution, and invested entirely in eligible assets dedicated solely to those liabilities. These would be Federal Funds or Treasury obligations of no more than three months maturity. As in case (a), interest might be paid on Federal Funds in such segregated portfolios.

In either case, deposited currency accounts would not have to be insured against illiquidity or insolvency, only against malfeasance by the agent or depository, a much smaller risk. Thus, a part of the payments system would be secure without the help of deposit insurance. Members of the public who value the security of currency at sacrifice of interest, largely the poorer and less sophisticated population, would be accommodated. Moreover, assuming statutory limits on insurance of other deposits are made effective, depositors who wish safety and liquidity on larger sums would be served.

I should like to make clear that, unlike my good friend and former student Robert Litan (1987), I do not propose the offering of accounts of this kind by banks as an option for which the bait is permission to engage in financial and nonfinancial activities now proscribed. I separate the issues and advocate these accounts for their own sake.

"Commercial banks" redefined

I would carry further departmentalization and asset segregation in banks and other depositories. A "commercial bank," generally an affiliate of a bank holding company, would be confined to liabilities eligible for deposit insurance, although only up to specified limits per depositor (not per account.) Deposits in other affiliates or other financial institutions would not be federally insured.

"Commercial bank" asset portfolios would be subject to regulations, and generous capital-account reserves against losses on these portfolios would be required. Fixed-nominal-interest bonds and mortgages of long maturity are not suitable assets for insured depositories, especially in an era of volatility of actual and expected interest rates and inflation. Asset portolios heavily concentrated in consumer paper and credit card debts are clearly unsuitable. Commercial banks, with insured deposits, should hold diversified portfolios of relatively short-term paper, including Treasury bills as secondary reserves, marketable commercial paper, non-marketable commercial loans, consumer debts, and longer-term variable-rate bonds and mortgages. They should not be using depositors' money to play zero-sum games in foreign exchange, interest rates, and securities prices. ,

As for the capital-account requirement, this could take the form of the most senior securities, preferred stock or debt, of the holding company of which the bank is a subsidiary, equal at least to a federally set fraction of the bank's assets, surely not lower than 5 percent. The capital requirement would be larger if, as is suggested as a possibility below, the bank holding company also has an underwriting affiliate.

Note that the defining characteristics of commercial banking would be the incurring of insured deposit liabilities as well as the making of commercial loans. The absurdity of nonbank banks would be ended, with some transitional grace period for the existing ones to convert.

The linking of deposit money and commercial banking is an accident of history, rationalizable by "real bills" doctrine because of the short-term nature of the assets and their financing of inventories and work in progress. Commercial lending is an important economic function. A banker formerly was expected to be an expert in appraising the risks of particular loans, and his continuing relation to borrower-customers served both them and the economy at large. Although the proposed "deposited currency" partially breaks the link of deposit money to commercial lending, that historic link is continued and even reinforced by the proposed redefinition of commercial banking.

One corollary of the redefinition is abolition of the distinction between banks and thrift institutions. The distinction has been crumbling anyway, as savings and loan associations turn themselves into banks, functionally and legally. Under the proposal, those associations could place most of their mortgages into an investment affiliate without insured deposits and their insured deposits into a commercial banking affiliate.

Likewise, the two federal insurance systems, the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance corporation (FSLIC), would be consolidated.

Of course, many depositors will prefer the checking accounts, savings and time deposits, and CD's of these commercial banking departments to deposited currency because they will generally pay higher interest rates. It is this affiliate that would be subject to fractional reserve requirements and have the privilege of borrowing from the Federal Reserve. As now, these banks would be the major fulcrum of monetary policy.

Digression on reserve discipline

The basic requisite of monetary control is that the central bank control the supply of something the private sector demands. In the United States, this something is base money, and the marginally active demand is that of the depositories for reserves to satisfy legal requirements and to meet clearing debits to other depositories. Reserve discipline can be maintained whatever the legal fractional reserve requirement. Franklin Edwards suggests (this volume, Chapter 1) that no reserves need be required. He is correct if he means, as I assume, that depositories must meet a zero requirement in the same way they have to meet a positive one now, that is, by having reserve balances, averaged over the computation period, not less than those required. If the fraction were zero, a depository must not be "overdrawn." If depositories can borrow or overdraw without limit, then, of course, there can be no reserve discipline. If they cannot, the central bank could retain control even if the required fraction were negative, permitting overdrafts up to a prescribed line of credit.

While it is possible to operate the system with zero reserve ratios, that does not mean it is a good idea. For one thing, distributional, equities are at stake. The taxpayers would lose the cheap placement of part of the national debt in required interest-free holdings. Moreover, a zero required reserve would mean that demands for Federal

Funds would depend entirely on individual depositories' precautionary decisions to hold excess reserves and to borrow at the discount window. These depend on uncertainties that the central bank would find difficult to forecast in aggregate. The more predictable demands for required reserves would be nonexistent.

The United States bases reserve requirements on deposit liabilities, but this convention is not essential. They could be based on asset volume, exempting an amount equal to capital. Computerization is likely to lead to increasing extension of overdraft credit lines by commercial banks to their depositors. If so, deposits will be an ambiguous and unsuitable base for reserve requirements. Assets, including overdrafts in use, will be more meaningful.

Daylight overdrafts create a short-run problem of reserve discipline, distinguishable from the regular reserve tests based on comparison of averages of end-of-day deposits and reserve holdings. It is difficult for a layman to understand why a depository using Fedwire cannot be held to a continuous requirement that its balance be not less than zero or some other prearranged amount. Leaving aside computer capabilities, which I presume can eventually be upgraded, I guess that the problem is that the depository cannot know all the debit charges to its Federal Reserve account. If this is because it has delegated the initiation of wire charges on its account to its clients, that practice should not be allowed. If it is because various employees are authorized to make such transactions, then the bank should hold enough excess reserve balances to make sure it is not overdrawn within a period when some responsible officer of the bank can learn what his agents are doing and take the necessary steps. If it is because check clearings deplete the account in amounts and at times the bank does not control or know, then excess overdrafts restricted to this quantity could be allowed until the end of the day, as was the practice before the dominance of wire transfers.

The Federal Reserve's nightmare appears to be that a run on a bank on a given day could lead to large overdrafts that could not be settled at the end of the day without generous Federal Reserve credit. The Federal Reserve would have no choice but to grant it, because otherwise a whole chain of payees would not hold the credits to their accounts they expected. The Federal Reserve's credit might have to continue day after day if the initial run were not reversed. It seems to be in the Federal Reserve's power to impose enough continuous discipline to avert this nightmare.

Tighter control by the Federal Reserve would presumably lead to tighter control by banks over customer overdrafts. A movement to a "debit card" or giro system, eliminating float, is greatly to be desired. For maintaining control, the giro sequence of payments orders and information—payor to payor's bank to central clearing to payee's bank to payee—is preferable to the check sequence—payor to payee to payee's bank to central clearing to payor's bank. Incidentally, the giro system would eliminate the considerable volume of transactions undertaken to earn double interest during float. Even under the check system, these transactions could be made unprofitable by prohibiting banks from paying interest on funds deposited before they are actually collected.

Investment affiliates

I would allow a bank holding company to have one or more investment bank affiliates, whose liabilities would be entirely uninsured, and whose assets would be free from commercial banking restrictions. Such an affiliate, I should think, would be subject to disclosure requirements like those of the Securities and Exchange Commission and to balance sheet restrictions like those of the Investment Company Act of 1940. An investment banking affiliate would not be allowed to trade with or borrow from the commercial banking affiliate.

Owners of claims on the investment bank could be offered facilities for redeeming their claims and simultaneously transferring the proceeds to third parties, as owners of mutual funds have now, but not for transferring the claims themselves. To provide these facilities, the investment affiliate would presumably hold a checkable deposit in its commercial banking sister.

The commercial bank would be, as now, limited in the proportion of its assets representing liabilities of any one borrower, and a similar rule would apply to the total claims of the commercial and investment banks combined against any one (nonfederal) entity. These restrictions should prevent abuse while allowing the two banks together to develop an efficient broad-spectrum financing relationship with a customer.

For a current commercial bank or equivalent insured depository, an investment affiliate would be established by the transfer of uninsured liabilities and equivalent value of assets from the commercial bank. These transfers would move the commercial bank towards compliance with the new and stricter regulations about asset portfolio composition. Of course, the transition will have to allow ample time for orderly compliance.

Who should be allowed to do what?

I turn now to the first set of issues. However, I cannot share the frenzy of excitement about them, provided the monetary and depository system is reformed along the lines I have outlined.

Deregulation in perspective

I suggest skepticism of blanket deregulation, justified simply as an application of general propositions on the optimality of the outcomes of free competitive markets. There is nothing in Adam Smith, or in Arrow and Debreu, that justifies the naive confidence of the deregulation ideology that unfettered growth and unrestrained combinations of firms—vertical, horizontal, conglomerate—will yield the socially best allocations of resources to activities. Oligopolies, monopolistic competition, nonprice competition, and non-market third-party effects (externalities) are excluded by assumption in any careful statement of Invisible Hand propositions.

Combinations supplant market transactions with internal administrative procedures. Adam Smith and his disciples to this day have viewed competitive markets as the mechanisms of social coordination and cooperation, of specialization and the division of labor. It is ironic that free market enthusiasts are so ready to promote combinations, which remove resource allocations from market discipline.

The case for bigness depends on economies of scale and scope. The case against is that bureaucracies are inflexible and inefficient—the same case that free market exponents make against government. So far as I know, there is no convincing theoretical or empirical demonstration that the markets for businesses, so active nowadays, resolve the conflict rationally and optimally. That combinations will be made, if allowed, if and only if they are in society's interest is simply an ideological article of faith.

Synergies in production technology and management seem very often to be less crucial considerations than empire-building. Managerial remuneration and prestige depend on size and on the height of the hierarchical pyramid. The market in businesses has not been very successful even in improving profits, let alone adding to national economic welfare. Financial pages report regularly the divestments of divisions or affiliates acquired only a few years earlier amid fanfare about synergistic fit.

Even when combinations increase profits, they may not be economic in a more comprehensive sense. Private gains may come, thanks to quirks of tax law, at the expense of taxpayers. Or as in the financial industries of concern to us here, they may arise from taking aggressive advantage of federal safety nets, deposit insurance, and last-resort lending.

Although financial markets come closer than nonfinancial markets to the perfect markets of economic theory, nonprice competition is rampant in financial services. It is easy to proliferate "products," and competing financial firms devote considerable resources to differentiating and advertising products. As the competition for Individual Retirement Account money exemplifies, the alleged differences are generally trivial and superficial. Arrow-Debreu theorems do not apply when the list of products is endogenous. Chamberlinian "wastes of monopolistic competition," or of oligopolistic competition, are a real possibility.

To an extent not shared by most other industries, monetary and financial institutions involve some externalities, public goods and bads, and their functioning in the public interest requires wide availability of accurate information. The payments system and the integrity of the medium of exchange are public goods. The sovereign monetary fiat, partially delegated to private agents, must be protected. Consequently regulations are essential, although not necessarily those that now exist. In addition, there is a general conservative principle. Just as "old taxes are good taxes," old regulations may be good regulations in the sense that it is better not to repeal them even if they would not be adopted *de* novo.

Are there significant synergies?

Economies of scale in banking do not appear to justify megabanks. The evidence is that these economies are exploited by medium-size banks, which do better than both very small and very large firms. No doubt there are some efficiencies to be realized by branching and interstate banking, but we do not need an oligopoly of a few coast-to-coast giant banks.

Economies of scope are the major rationale invoked for allowing conglomeration of various financial activities under common ownership and management, even in combination with nonfinancial businesses. Evidence of their importance, especially for the economy at large, remains scanty. I doubt there could be detectable increment in GNP. Indeed, I suspect that involving even more bright people in frenzied financial activities could be counterproductive.

"One-stop" banking and financial servicing is a popular slogan, but it tends to fall apart under close scrutiny. Collecting various services under one roof will not make your visit "one-stop" except for parking your car. Inside the supermarket you will have to visit, and wait for, the various specialists—teller, broker, insurance agent, mortgage officer, auto loan manager, and so forth.

"One-statement" finance is probably another mirage. At least in my experience, combined statements do not diminish paper overload and are confusing and prone to error. Moreover, it is predictable that the multiproduct financial firm is going to proliferate extravagantly promoted tie-in deals, just about as advantageous to the customers as the life insurance the lender's agent assumes you want when you take out a mortgage or an auto loan.

Common location does not necessitate common ownership. Distinct specialized firms can have offices in the same building or shopping center, or even within a bank's premises.

Anyway, is not "no-stop" finance the wave of the future? Will not telephone lines and computer networks replace automobile trips? You may pay for your groceries at the checkout by inserting a card, and pay your bills likewise at more versatile ATM stations conveniently located, even at your own phone. You may manage your investment portfolio the same way. The current examples of ATM's and credit cards indicate that these facilities can be provided without combination and conglomeration.

That is true also of transactions other than those of consumers. While a large bank can mobilize the excess deposits of some branches to finance the excess loans of others, the same function is performed by secondary markets in mortgages, loans, securities, federal funds, and interbank deposits. As noted above, the question is whether internal administration can do these things better than the markets.

Robert Litan (1987, Chapter 3) finds the major case for activity diversification not in technological and managerial synergies but in risk reduction. Possibly the variance of earnings on assets and on net worth can be diminished, without sacrifice of expected return, by conglomeration, especially if returns on new activities are negatively correlated with those on traditional banking operations. On the other hand, the new activities may be instrinsically more risky.

I am afraid I do not find this case very convincing. I have argued that the moral hazards of federal safety nets have to be attacked head on. Companies owning banks must be prevented from placing the risks of their various activities on those safety nets. Once that is assured, conglomeration may not be so attractive. And in one sense it seems redundant. It might be that the profitability of chewing gum turned out empirically to be strongly negatively correlated with earnings in banking. Does it therefore make sense for chewing gum companies to operate banks or vice versa? Individual savers do not need conglomerate firms in order to diversify. They can do so, possibly with the help of mutual funds, in their own portfolios, and could do so even in a world of firms with specialized product lines.

Should nonfinancial activities and commercial banks, as redefined above, be combined under common ownership and top management? My judgment, like that of Paul Volcker and Gerald Corrigan (1987), is not to allow such marriages. The danger that the bank would be used to assist the nonfinancial activities, increasing the risks to depositors and to the federal government, is too great, whatever regulations are written to forestall such abuse. The countervailing social advantages do not seem important. Anyway, in the structure I sketched above, nothing would stop conglomeration of nonfinancial business and nonbanking financial activities.

Should bank holding companies, which by definition would have a commercial banking affiliate, be allowed to underwrite securities? This is a difficult judgment call, and I do not feel at all expert. I see the advantages to the bank holding company and to its customer of a relationship that covers short-term finance (the commercial bank affiliate), long-term finance (the investment bank affiliate), and underwriting services (still another affiliate). This seems a more likely synergy than those alleged for consumer banking and finance. Underwriting is a risky activity, however, and depends on a range of skills different from banking, in particular those involved in the "due diligence" investigations required by the Securities and Exchange Commission.

I would require an underwriting affiliate to be heavily capitalized, and I would raise the senior capital protection requirement of the commercial bank affiliate of any holding company doing underwriting. Limits on the commercial and investment bank holdings of any one company would prevent the underwriting affiliate from regarding its sisters as fallback customers. Likewise, the underwriters would not be allowed to borrow from their sisters.

Prohibiting the use of deposits, especially insured deposits, from financing underwriting would make banks less threatening to that industry than usually touted, but even so, thanks to the general financial expertise of banks, their competition could reduce the toll-booth profits now protected by Glass-Steagall.

Conclusion

In summary, the strategy I favor is, first, to restructure the systems of depository institutions so as to reduce significantly the moral hazard of federal safety nets, particularly deposit insurance. I would not turn banks loose to enter new fields, or throw the gates of banking open to nonbank firms, as long as it remains possible for additional risks to be passed to depositors, taxpayers, and prudent members of deposit insurance systems. Once a restructured system of depositories was relatively immune to this danger, I would let commercial banks have investment banking and, possibly, underwriting affiliates. But I would draw the line at letting nonfinancial firms have banks, anyway the kinds of banks that would do them any good.

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Commentary on "Proposals for Financial Restructuring"

Robert E. Litan

These are two excellent papers that span the spectrum of current economic thought about the wisdom of expanding the powers of banks or their holding companies. Despite their difference in perspectives, each paper significantly advances the level of debate over the restructuring of the financial services industries. I hope to demonstrate this as I briefly lay out for you how I approach this topic.

I begin with a proposition that is implied in Thomas Huertas' paper: Regardless of what one thinks about the merits of financial product deregulation—and despite his disclaimers, that is what we are talking about at this conference—continuing technological advances and market forces make the blending of financial service offerings inevitable. This has already been recognized in England, and most recently in Canada, which have permitted bank affiliations with other financial enterprises.

Here at home, even though Congress has been stalemated on the bank powers issue, the *states* have been taking matters into their own hands by gradually expanding the activity authority of the banks they charter (Saulsbury, 1987). Indeed, I forecast that once the states allow nationwide interstate banking—now probably less than five years away—they will turn with vigor to bank activity deregulation. The Federal Reserve may try to control this process through its jurisdiction over bank holding companies. But its legal authority to do so is unclear. Moreover, if holding companies begin to disband and place their nonbank activities as subsidiaries of their state-chartered banks, the Federal Reserve would be powerless to stop them. In short, just as the states led the way toward interstate banking, they are likely to be the agents of change on the product-line front.

Neither Huertas nor James Tobin discuss this scenario, even though in my view it is the most likely way in which the debate over financial restructuring will be settled. However, Tobin's warnings about the risk-creating incentives of deposit insurance coincide with my own reservations about letting financial product deregulation proceed at the state level. My concerns center around the fact that state deregulation means that nonbank activities will be conducted ***directly*** out of the bank or through a bank subsidiary. In either case, as William Seidman noted yesterday, the nonbank activity appears directly on the asset side of the bank's balance sheet. To be sure, it may be less costly for banks to enter other activities directly rather than through holding company affiliates. But if the insurance, securities, or real estate operations fail, the capital of the bank will be ***directly*** impaired. And if the impairment is sufficiently serious, the Federal Deposit Insurance Corporation (FDIC) will then be called upon for a rescue. In short, the FDIC ends up insuring not only depositors but nonbank operations as well—a result I suggest that not many in this room would applaud.

It is noteworthy that the recent FDIC staff study has recognized this problem (FDIC, 1987). Its constructive solution is not to count as part of a bank's capital a bank's investments in nonbank subsidiaries. Nevertheless, I still worry about the ability of politicians or regulators to distinguish properly in advance between activities that belong directly in the bank and those that should be placed in bank subsidiaries. In addition, permitting banks (rather than their holding companies) to be the vehicles of product-line diversification blurs the division of responsibility among regulators. In effect, the federal bank supervisory agency—whether it is the FDIC, the Comptroller, or the Federal Reserve—must assume responsibility for supervising and regulating all of the activities conducted out of the bank or its subsidiaries.

For this and other reasons, most of those advocating financial restructuring have proposed that new nonbank activities not now operated by banks be conducted out of separate affiliates—belonging either to current bank holding companies with expanded powers or to new financial service holding companies. Huertas does an excellent job of summarizing these proposals in his paper.

Huertas' most useful contribution, however, is his lengthy discussion of steps that can increase the "R-factor" of the holding company arrangement, or insulation of the bank from its nonbank affiliates. This discussion is significant, because it is the most comprehensive attempt I have seen yet from a banker—and even from Huertas himself—to come to the grips with the insulation issue.

At bottom, Huertas has two central recommendations. First, in line with a now famous article written by Fischer Black, Merton Miller and Richard Posner (1978) nearly one decade ago, Huertas urges policymakers to look to bank capital for the necessary protection—that is, require banks belonging to highly diversified organizations to maintain an extra layer of capital and then force their divestiture from the rest of the enterprise if actual capital falls below a threshold minimum.

Second, Huertas argues that the Federal Reserve should get out of the business of regulating bank holding companies. Instead, he would pass the buck back to the Comptroller of the Currency to address the concerns that have prompted proposals to limit daylight overdrafts and to require banks to deal with their affiliates at "arms length". Significantly, Huertas would enhance the Comptroller's authority by giving him (or her) the ability to seek immediate court injunctions to stop unsafe or unsound bank practices (without going through the potentially lengthy hearings required in cease-and-desist proceedings).

In principle, this plan could work. But I find surprising, given what I know to be Huertas' firm faith in the market and his skepticism of government intervention, the faith he and apparently other market-oriented specialists in this field place in supervision and regulation to minimize the risks of bank activity diversification. I am not so confident. The bank divestiture or "bear down" requirement, for example, cannot be effectively implemented without much more frequent bank examinations than occur now. Otherwise, regulators will not be able to catch banks from coming to the rescue of their affiliates—until it is too late. As the former chairman of Citibank New York, Walter Wriston, stated in a now infamous remark in 1981, "It is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world" (Wriston, 1981). I would add that in the "real world" our regulators failed to catch Continental Illinois, Penn Square, and Seafirst before each required rescue or depositor payoff.

In addition, Huertas does not tell us whether his additional capital requirements would be based on market value (rather than historical cost) accounting. But if market values are to be used, we are left to wonder how at least in the near term the nontradeable loan assets banks carry on their books are to be priced with sufficient accuracy to use market-based capital amounts as triggers for bank divestiture.

Yet, even if regulators had an accurate trigger, Seidman reminded yesterday of another important fact from the "real world". The day the FDIC steps into a bank, its resale value can fall by up to 25 percent. That should tell us that the FDIC can still remain very much at risk even with an "intelligent" bank closure policy.

Huertas' insulation devices also fail to address two other potential problems. One is the danger that bank depositors will run if nonbank affiliates are threatened. However irrational this behavior may look, it happened in 1973 when a mortgage banking affiliate of a bank in Beverly Hills, California failed. It can happen again, especially as we move to the "Brave New World" of full product deregulation.

Second, those who advocate a regulatory approach to increasing a bank's R-factor must recognize the danger that politicians will turn the "R" into an "X". Specifically, I suggest that if and when opponents of bank product deregulation recognize they are on the losing side of the debate, they will switch tactics by urging Congress to enact a "telephone book" of statutory rules and restrictions to wall the bank totally from its nonbank affiliates. The first entry in this telephone book, I predict, will be restrictions prohibiting a bank from cross-marketing its services with those of holding company affiliates. Indeed, provisions of this type were written into the 1987 banking legislation just signed by the President this month. As Huertas correctly notes, such restrictions eliminate the scope economies from jointly delivering multiple financial services and, thus, dramatically reduce incentives for banking organizations to diversify.

As some of you may know, I have advocated "narrow banking" as a way of avoiding the telephone book problem while addressing the major risks of permitting bank organizations to diversify freely (Litan, 1987). I do not claim credit for the idea. Others, including Carter Golembe, John Karaken, and Al Gilbert, have also written about the concept. Indeed, the origins of narrow banking go back to the 100 percent reserve proposal discussed by Henry Simons and Irving Fisher.

Briefly, I have proposed the creation of a new ***voluntary*** option for organizations that want to own an insured depository and also to engage in an unrestricted set of nonbanking activities, financial or commercial, beyond those currently allowed for bank holding companies. In exchange for broader powers, these highly diversified organizations would have to confine the activities of the insured institution solely to accepting deposits and investing the proceeds in safe, liquid securities—Treasury securities or instruments guaranteed by the federal government or by a quasifederal agency, such as Ginnie Mae or Fannie Mae mortgage securities. Significantly, these "narrow banks" could not make loans. Instead, the diversified conglomerates would conduct any lending activities out of separate affiliates funded by uninsured liabilities or equity (much as General Electric Credit Corporation or Commercial Credit operate today). To made a transition possible, I would allow existing bank holding companies to exercise broader powers as long as they adhere to a ten-year schedule for steadily transferring loans out of their banks into the new lending entities.

Several other features of the plan are worth noting. Only the narrow banks, but not their affiliates or holding companies, would have access to the payments system. Furthermore, nonbank affiliates could not have deposit accounts with their related narrow banks, eliminating any threat to the payments system from nonbank activities. Finally, I would place no restrictions on cross-selling of services by banks and their affiliates or on operation with common names and employees out of common locations.

In shod, both the R-factor and telephone book problems can be solved simply by requiring highly diversified banking organizations to reverse the historical accident noted by Tobin by separating their deposit-taking and lending activities. If the nonbank operations of financial supermarkets failed, the insured bank would be protected, both because it would be fully securitized and, thus, could withstand a run and because it would not be able to prop up the affiliates by lending to them or their customers. In addition, there would be no need for a telephone book full of regulations aimed at potential conflicts, tie-ins, and other abuses, because the depository arm of these conglomerates simply would not be able to lend to customers of other parts of the organization. Last, but not least, narrow banks are tailor-made for Edward Kane because they can be easily required to adhere to market-value accounting.

Tobin's proposal to reduce the risk of insured depositories is very much in the same spirit. But as he himself stresses, his proposals to create "deposited currency" and to redefine commercial banks have a different purpose: to correct abuses in deposit insurance rather than to permit banks broader product-line freedom in a risk-minimizing way.

To this degree, the Tobin proposal is even more radical than mine because it would require all banks—and not just those belonging to diversified supermarkets—to change their asset portfolios.

My agenda is different. Because I believe that financial product deregulation is inevitable, the sooner we structure the process in a socially optimal way the better off we will all be. I therefore support relatively severe restrictions on bank asset holdings as the necessary social price for allowing bank organizations to diversify freely.

My version of narrow banking differs from Tobin's in another significant respect. Tobin wants to prohibit or severely constraint *all* banks from assuming interest-rate risk—by restricting their assets to short-term loans and investments and to only those long-term assets with variable rates. However, it seems to me that the recent abuses of the deposit insurance system have not primarily involved excessive interest rate risk, but simply bad loans. That is the main reason I would structure the assets of narrow banks to eliminate credit risk by limiting them to holding federal securities. In addition, Tobin's definition of narrow banks would not solve potential conflicts problems in a deregulated environment because his banks would still be free to extend loans to customers of the nonbank affiliates.

Nevertheless, Tobin's narrow banks may have an advantage over mine if we move to broader product deregulation, an objective that I understand he does not endorse. Specifically, if, as I suggest, narrow banks in diversified organizations are to be prohibited from extending loans, then the loan-making function would increasingly be performed by uninsured institutions. As a number of people within the Federal Reserve System have argued, this could expose the uninsured lenders to the equivalent of deposit runs if they could not "roll over" their liabilities (Parry, 1987). I believe this risk is overestimated for three reasons. First, only the least risky banking organizations would even be able to take advantage of the narrow bank option because only they would have loan portfolios of sufficiently high quality to be funded by commercial paper or other uninsured debt or equity. Second, precisely because their liabilities are uninsured, the lending affiliates of narrow banks would have higher capital ratios than conventional banks. Third, now that the commercial paper market, like the market for conventional debt and equity, is highly developed, I do not accept the argument that if one lending institution that relies on commercial paper for funding (such as General Electric Credit Corporation) fails the commercial paper market in general will collapse. Nevertheless, whether or not I am correct, it is worth noting that the application of Tobin's narrow bank model in a deregulated climate would pose less risk of a credit run because Tobin's banks would still be able to make loans.

In sum, both Huertas and Tobin have provided highly stimulating papers on an issue that needs some new thinking. I share Huertas' desire for further deregulation but lean in Tobin's direction (with suitable modifications) for policy solutions.

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Commentary on "Proposals for Financial Restructuring"

Steven M. Roberts

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, antitie-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.

Overview

E. Gerald Corrigan

Trying to do a wrap-up at this conference is not very easy. 'An awful lot has been said, and I agree with much of what has been said. But I want to make a few comments from my perspective.

Let me start with some rifle shots on individual points that I think are important in terms of trying to get the best possible perspective on the subject. These rifle shots come in no particular order but are my reaction to things that I've heard here.

Clearly there is a broad-based consensus that something has to be done about restructuring our financial system. There is even a broad-based consensus as to why it has to be done. I certainly would count myself among those who put considerable urgency behind the task of getting it done. I think Henry Kaufman touched on some of the reasons for that urgency, as have others. To put it into a nutshell, the need for action stems in part from the fact that a lot of what we are seeing in financial markets here and around the world is a product of the past five years of bull markets. One has to ask the question: How is it all going to look in the context of bear markets? Because certainly none of us, I suspect, would be so casual as to suggest that the business cycle and interest rate cycle are things of the past. That is my first rifle shot.

Secondly, there was some talk about goals—especially by Steve Roberts this morning—and I think that is very important. There is one goal that often goes unstated, so let me state it. That relates to what we call systemic risk and it is an overriding consideration. It involves trying to protect the system as a whole, as Henry Kaufman puts it, against the possibility of a highly destabilizing "accident" that could undermine prospects not just in the banking or financial arena, but in the economic arena more generally. Such a possibility inevitably and automatically brings into play the so-called "moral hazard" problem. And the dimensions of that moral hazard problem I think do get more complex in a world today so characterized by speed and by the interdependencies of interconnections, domestically and internationally, that are now so commonplace. There is a natural tendency, as we have seen in these discussions, to think of that moral hazard problem as being exclusively or largely associated with so-called insured deposits. But the problem is broader than that, because there is at least a danger that the kind of systemic problem that could arise need not be one that in the first instance is uniquely associated with insured deposits.

The third rifle shot that we've got to keep in mind is that the public, and indeed the Congress, will demand financial stability. One of the interesting and very relevant points in Bill Seidman's paper I thought was about the swings in the pendulum in so far as attitudes toward regulation of the banking and financial system. Crises and disruptions do produce reactions and sometimes those reactions are not necessarily what we would like to see, but surely they are there. But the public certainly will demand stability, and in that sense we have to be at least mindful that we don't want reform for the wrong reasons. If we get reform for the wrong reasons, we can safely assume that it would be the wrong kind of reform.

In connection with this point about the public demanding stability, I'll share with you a recent anecdote of history that I think is relevant. For the first time, right now, we in the United States have embarked upon a program of formal regulation of the government securities market. And that formal regulation has, among other things, been supported by the market itself and by the Treasury Department. It's a rather astonishing thing, if you think about it. Because the government securities market, of course, was *the* market that was thought to be immune from the need for any kind of regulation. But what happened, of course, is over the period of several years a number of accidents took place on the fringes of the marketplace. These accidents by and large did not damage small unsophisticated investors, but hurt school districts, state and local governments and even, as I recall, a Congressional credit union. It is a simple but stark reminder to all of us that the public will demand stability in the banking and financial arena.

Another point that is very, very important is the distinction that Steve Roberts made this morning. There is a lot of talk about the safety net and particularly on two important elements of the safety net: deposit insurance—whatever one may think of it—and the discount window. But there is some tendency to forget that the process of supervision and regulation itself constitutes the third leg of the safety net. It's not the payments system. Access to the payments system is part of the ***quid pro quo*** that goes with being subject to supervision. But I do not regard the payments system in and of itself—or access to it—as part of the safety net but a privilege extended to banks as part of their public role and as part of the ***quid pro quo*** for regulation.

One other quick observation is that in all our deliberations we have to keep in mind not only what is necessary or what is desirable, but also what is feasible.

In some ways the central question before this conference—around which there is probably a sharper difference of opinion than any other—is the question of whether there should be merging of banking and commerce. It should come as no surprise to anybody that I am rather strongly opposed to that and I don't think it has anything to do with being in the Federal Reserve. In my judgment it is the soundest approach to public policy over the long haul. I am not going to suggest that the answer I give is wholly without doubt. But we do have to pose this question in terms of the risks and rewards for taking a particular point of view in this area of public policy.

It is very important to keep in mind that one of the purposes of the Bank Holding Company Act is to permit a certain amount of interaction between banks and other affiliated companies. It is designed to permit that interaction, not to wall it all off, in a context in which adequate safeguards are taken, ultimately in the form of consolidated supervision. The bank holding company structure, with its separate affiliates and all the rest, makes a lot of sense for other reasons including facilitating the proverbial "level playing field" from a competitive point of view while facilitating functional regulation as well. Thus, based on the merits, I'm not ready to turn away from that structure. I would also suggest that if we're really serious about permitting a full blown merging of banking and commerce, that there is only one relevant, somewhat contemporary, example that I know of to serve as a model. That is the so-called Zaibatsu banking commercial system in Japan. The history of the kinds of problems that evolved from those circumstances makes for very interesting reading, I can tell you.

As many of you know, I have spent a lot of time over a number of years thinking about the wisdom of maintaining the separation of banking from commerce. If anything, I believe I've moved further in the direction of solidifying my judgment that it is in the public interest to have a legislative framework that prevents commercial firms from owning and controlling banks unless there is some absolutely compelling reason to permit such combinations. Since I see no such compelling reason at this time, I remain opposed to such arrangements.

The case for permitting commercial firms to own and control banks is based on a view that says either that there is nothing inherently wrong with such combinations or that such combinations can provide economic benefits in a framework in which regulatory and/or managerial protections can be put in place that will insure that public interest considerations are adequately served. I, for one, have grave doubts on both accounts. In order to make that case, let me begin with several points of reference.

First, when society vests with a select group of institutions, certain privileges such as deposit insurance, access to the payments, credit and liquidity facilities of the central bank, and the implicit sanctions of official supervision, something of a social compact is created whereby the institution accepts certain responsibilities, most notably the responsibility to conduct its affairs in a safe, prudent, and impartial manner.

Second, the central question at issue with respect to the banking-commerce separation doctrine is whether it is desirable for wholly unregulated, unsupervised commercial concerns to be able to own and control depositories having access to the overall Federal financial safety net. In seeking to answer the question, we should, for starters, keep in mind that if we in the United States go that route, such arrangements would be unusual among the industrial countries of the world in that in no other major countries are banks, as a general matter, owned and controlled by commercial companies. To be sure, in some countries, such as Germany, banks have greater flexibility in the extent to which they may hold equity interests in commercial companies than is the case in the United States, but commercial ownership and control of banks are not common.

Third, if, as a legal matter, commercial concerns are able to own and control banks, it seems apt to ask would they choose to do so and if so, why? To some extent we know the answer to the first question since at least some commercial firms already own insured depositories and others seem to have an interest in doing so. Why, there can be only three possible answers. First, among the alternative uses of capital, they visualize the relative returns available in banking as superior; second, they see synergies in the combination of banking with existing lines of business that will permit them to maximize the overall return on capital; or third, they see economic advantages in gaining access to one or more of the privileges associated with banking such as access to the market for insured deposits or direct access to the payment system. Of course in reality, the motivation might well reflect some combination of the above factors. The key point, however, is that if the motivation for commercial companies to own banks is even partly related to the second and/or third explanation cited above, there are clear dangers in permitting such combinations.

Fourth, one might be more inclined to run those risks if there is some absolutely compelling public policy reason to do so. Satisfying the business interests of a relative handful of corporations does not strike me as a compelling public purpose. On the other hand, if there was (1) strong evidence of an absence of competition in banking, (2) strong evidence that combinations of banking and commercial concerns would unleash powerful new economies of scale which did not run afoul of public interest considerations, or (3) if the banking industry was suffering a chronic shortage of capital, one would look at banking and commerce in a different light.

While a case can be made that the capital base of the banking industry should be further bolstered, it is by no means clear that the only way, or the best way, to remedy that problem lies with permitting commercial firms to acquire and control insured depositories. Indeed, it is not even clear that permitting commercial firms to make such investments would materially augment the true capital base of the banking industry. Whether, and the extent to which, that result is achieved would depend, among other things, on the nature of such investments, the prices paid, and the manner in which the investment is financed by the commercial company. More importantly, at the end of the day capital will be attracted only by underlying profitability. Merely permitting commercial ownership of banks would seem to do little to change that unless the owners were permitted to push extensive interrelationships which is the very source of my concern.

Fifth, a final consideration which is of relevance in evaluating the case for or against the separation of banking and commerce is the rather straightforward matter of how businesses conduct their affairs. That is, when we look at the manner in which large diversified bank holding companies, financial conglomerates, or even commercial-financial firms are managed, do we see—especially in times of stress—an integrated approach to management, or do we see parents and offspring each willing and able to go its own way even when one or the other is faced with adversity?

While some observers cite a limited number of examples which they believe provide evidence of failsafe managerial firewalls, I believe that any objective examination of the evidence—evidence that runs the gamut from advertising to episodes in which firms have taken large losses even in the face of ambiguities about their legal liability—leads conclusively to the view that firewalls are not failsafe and that, far more often than not, large financial concerns are managed and operated as consolidated entities. Looked at differently, the mere need to set up an elaborate system of firewalls says something about the basic issue of whether it makes good sense to prompt such combinations in the first place.

Taking all of those considerations into account, there are two major classes of risks that must be considered if we are prepared to permit the blending of commerce and banking. The first set of risks are the historic concerns about concentration, conflicts, unfair competition, and breaches of fiduciary responsibilities. Interestingly enough, even most proponents suggest that the problem can be dealt with by regulation. However, if regulation is effective, it will, by definition, eliminate the synergies of any such combination such that the commercial firm in question is left only with a truly passive investment. If that is the objective of the commercial firm, there is nothing to prevent such firms from making large equity investments via the open market in any number of banking or financial entities so long as any one such investment does not achieve control over the company in question. Indeed, a commercial firm can buy up to five percent of the stock in any one bank without even having to disclose such an investment.

The second set of risks associated with permitting the merging of banking and commerce are the dangers that such arrangements will involve the ***de*** *facto* extension of parts of the safety net to any firm that would own and control banks. In response to this point, the proponents argue that the situation is really no different than the situation we have today with the bank holding company. In fact, there is a very big difference and that difference is that the bank holding company—as an integrated whole—is subject to official supervision. Moreover, in the reform plan I have suggested, *all* component parts of a bank or financial holding company would be subject to some form of official supervision, much as they are today, *and* the company as a whole would be subject to at least a degree of consolidated official supervision.

There is another way to look at the problem. Namely, I assume that even the proponents of merging banking and commerce would agree that the acquisition of a bank by a commercial company would be subject to some sort of official approval process. I assume they would also agree that a part of the application process would have to focus on the financial strength of the acquiring firm as well as the regulatory and managerial firewalls which they agree should be constructed. I assume they would further agree that some such applications would be approved while others would be denied and that some form of ongoing monitoring would be necessary. In making this point, it should be emphasized that commercial firms wishing to own banks undoubtedly will not be limited to a few "blue chip" companies. To the contrary, the list of *potential* acquirers will include all comers—something I am convinced we should be especially sensitive to in this era of merger mania in which even solid firms can be forced into elaborate defensive financial strategies which undermine their balance sheets.

Therein, of course, lies the dilemma; that is, even the official act of approving an application of a commercial firm to acquire a bank seems to carry with it the extension of at least some elements of official oversight to the acquiring firm in a manner which brings with it—at least by implication—an official blessing of the transaction and the relationship in question. As I see it, this subtle but certain extension of the safety net is not something we should take lightly since we must be prepared to live with the consequences in foul weather as well as in fair. Indeed, at the extreme the logic of the matter is unavoidable; if the bank cannot be fully insulated from the entity as a whole, the consequences are either that the safety net surrounding banking will have to be extended—at least to an extent—to all who would own and control banks, ***or*** the safety net should be eliminated altogether.

I would conclude by saying that from my perspective, substantial and progressive reform is urgent and I would like to think it is within reach. And one of the reasons why I think it is within reach is that I believe we should be able to get there without having destructive battles. I would be remiss, too, it I neglected to note that the international elements of these issues, which I haven't touched on, are equally important and equally compelling as we try to deal with the many aspects of financial market restructuring.

Overview

Carter H. Golembe

I want to add my congratulations to the Federal Reserve Bank of Kansas City for the excellence for the program. There is no question that they have managed to assemble—at least until reaching this particular point in the program—a large percentage of the "best and the brightest" when it comes to financial system reform.

The role of an "overview panelist," I was told, can be whatever one makes it. I opted to offer reflections on several of the conference themes.

Our keynote speaker, Franklin Edwards, said near the end of his paper, and then repeated in his oral remarks, that the paper was ". . . a plea for action—an appeal to end the political paralysis that now immobilizes Congress and regulators." It strikes me that this serves well as the principal theme of the conference: a call for restructuring or reform with respect to the banking and depository system, the distribution of powers among financial institutions, the regulatory structure, and, worth noting separately, the system of deposit insurance. It is a theme that was treated with varying degrees of intensity or urgency—not all speakers found quite the same degree of urgency as did Edwards. But nonetheless, it was a theme that wound its way through all of the papers and all of the discussions.

Our first speaker mentioned, but quickly dismissed, the option of "muddling through." This morning, James Tobin used a less kind expression. If I caught his words correctly, it was "anarchic and disorderly drift." Still, it might have been interesting if someone had given the "case for muddling through" or at least had sketched some of the possible consequences. I say this because, notwithstanding the unanimity at this conference that something should be done, there is a good chance that "muddle through" is what in fact may be in the cards.

If so, would the result be as Edwards predicts—an explosion or collapse of the system? Or would it be the picture, conjured up in my mind at least, from the Robert Eisenbeis paper—that of a huge wave of technological and financial change washing over the landscape, about to leave behind some rather limp irrelevancies once known as commercial banks and deposit insurance systems? Or would we in fact end up at about where we wanted to be all along, possibly led there by the states, as Robert **Litan** so cogently pointed out, although most likely at the cost of considerable delay and much additional expense? I just do not know.

There seemed to be little or no dispute over what is forcing change. My notes on the causes mentioned by various speakers overlap considerably. One thing that stands out is that technological change appears at the top of almost every list.

As to what needs to be done, in most instances there was substantial agreement, with only a few differences, largely of degree or over implementation. For example, broader powers for banks or bank holding companies passed, I sensed, by a rather comfortable majority. Of course, the receipt of additional powers was usually related to, or contingent upon, other reforms desired by the speaker. Securities powers headed the list when it came to additional banking powers.

As an aside, I should say that I was personally delighted to hear that the sacred line between banking and commerce is not quite so sacred in the view of a number of our speakers. However, it still seems live and well for a few others.

The urgent need for reform of the deposit insurance system also came through rather clearly, at least from those speakers—which means most—who addressed the subject. The most logical reform in my view, but the least practical politically, is fundamental reform, by which I mean returning deposit insurance to its origins—a limited purpose, social-welfare system designed to protect depositors of modest means against one of life's vicissitudes, a bank failure.

I should make a brief comment on the issue of whether a bank may be "too large to fail." The matter surfaced in floor discussion yesterday in a colloquy between Kenneth Guenther and William

Seidman; it was mentioned in Tobin's paper; and then it came up again today when Frank Morris introduced it. I agree with those speakers, such as Tobin, who argue that banks of any size should be allowed to fail. On the other hand, it is perfectly conceivable to me that the failure of any private institution, bank or nonbank, might have grave repercussions—so grave that the government might feel compelled to step in to protect the national interest. I doubt that Continental Illinois was such a case. But if it was, then it fell well outside of the deposit insurance system; it had no more relevance to deposit insurance than did Chrysler or Lockheed.

The Federal Deposit Insurance Corporation (FDIC) had an insurance commitment in Continental Illinois of about $3.5 billion, an amount well within the capabilities of the deposit insurance fund. I would argue that the FDIC should have been prepared to meet that commitment, and nothing else. If Continental Illinois had to be saved for reasons of state, then the decision and implementation responsibilities were with the Treasury, the Federal Reserve, and, given sufficient time, Congress.

The matter of priorities was raised by several speakers, Seidman and Tobin in particular. Both suggested that one should put a proper structure in place before proceeding to make any changes in the authority or powers that could be exercised by banking organizations. This does make sense. But I have to report that I had dinner last Saturday evening with one of the top bank lobbyists in Washington, who described to me in some detail how he expected to ensure that the moratorium on bank powers was not extended next March and how banking might then succeed in obtaining additional powers. He was quite optimistic, although he conceded that one of the few clouds on the horizon was that the banking industry might get itself mired down in debating various structural reforms. Having just finished Tobin's paper, I asked did he not think that, logically, the structural reform issue should be settled before one thought about congressional action to restore or expand the powers of banking organizations. His reaction was one of shocked disbelief. It may be some time before I restore my credentials with that gentleman.

On the matter of various institutional structures, I have just a few comments. First, it is heartening to see the growing acceptance of the idea that insulation of banks in a holding company framework is possible—that regulators can confine their attention to banking and not to related activities. As one who has argued this proposition for years, I know how lonely that position was, even four or five years ago. The regulatory agencies were virtually unanimous in dismissing insulation. We have come a long way when a chairman of the FDIC, at least one and possibly several governors of the Federal Reserve Board, and the Comptroller of the Currency agree that insulation is feasible.

Second, I have long favored Litan's "narrow-bank" approach to structural reform, although possibly I would be a bit less narrow than he in defining the assets that a bank with insured deposits must hold. I like his approach in considerable part because it accomplishes a basic deposit insurance reform, i.e., it makes deposit insurance largely unnecessary. But it could also solve many other problems, as Litan indicated in his remarks. Its flaw, possibly fatal if one takes a narrow Washington view, is its saleability, with the difficulty probably more pronounced in the banking industry than in Congress.

Accordingly, I favor the financial services holding company concept, which Thomas Huertas described so well, and in particular I think that the proposal made by the Association of Bank Holding Companies deserves support. That proposal, and others, in effect finesse the basic need for deposit insurance reforms by structural arrangements that insulate the bank and, therefore, limit the reach of deposit insurance and the government's exposure. Combined with continued experimentation in enhancing depositor discipline—say through the modified payoff proposal of the FDIC—the financial services holding company concept may be the most feasible, attainable approach.

I must confess, however, to a sneaking fondness for some elements of the Seidman approach, primarily for the reasons he gave Guenther in the luncheon discussion yesterday. If the Seidman approach can be pulled off, it is a far simpler, cleaner way of accomplishing some important objectives.

In this connection, I was fascinated by the political implications of the staff paper presented by Seidman yesterday. It is awesome in its audacity. Consider that the approach that he is urging is certain to irritate banking's competitors, and in particular the securities industry, when he proposes to repeal the Glass-Steagall Act. He cannot be making any friends at the Federal Reserve by proposing a repeal of the Bank Holding Company Act, in addition to dismissing a cherished belief of the Board of Governors that "the bank holding company should be a source of strength to the individual banks." And then he is in effect telling two of the largest banker associations in the country—the Association of Bank Holding Companies and the American Bankers Association—that their financial services holding company concept, on which they have labored so long and about which a summit meeting is scheduled for September 9-10, is not really needed. I wonder where he will find allies to support his proposed restructuring.

The question that remains with me as we begin to close the circle here this morning is, again, one posed by our first speaker. If the need to restructure is so clear, why is something not being done? Franklin Edwards placed the blame on the persistence of some myths, which he claimed hobble us severely. Edward Kane took a different swing at it, to the effect, as I understood it, that if only the voters knew what was being done by the regulators and the legislature—the hidden subsidies and the like—then reform would be possible.

I cannot disagree with Kane of course, except to say that there are other problems. And I agree with Edwards that the myths he cited need demolishing. The problem is that some have already been demolished and we are still mired down. I think, therefore, it might be worth taking a few moments to look more carefully at this matter.

A most formidable obstacle to reform is Congress, and there are two important facts to keep in mind when it comes to Congress. First, Congress is insulated from market forces to a considerable degree. What Congress responds to is not the market but the pleadings of its various constituencies, and the result often depends on the relative political strengths of those constituencies. One would like to believe that the ultimate constituency—the people or the public interest—is that to which Congress responds, but that is not often the case when it comes to financial legislation.

You would have to believe in the tooth fairy to believe that commercial banking lost its Glass-Steagall battles with the securities industry because it lost on the merits. The myth that Edwards mentions—that the separation of bank and securities activities is necessary for financial stability—has been thoroughly demolished. It is hard to find anyone in the agencies or, for that matter, on Captitol Hill who believes it. What the banking industry has failed to do is what the securities industry does so well, namely, mobilize congressional support; and among other things this means mobilizing sufficient cash and distributing it in the most productive manner.

It is easy to dismiss these grubby battles over turf as something that will go away if only we fix our sights high enough and deal with cosmic issues of reform. But you still have to get from "here" to "there." Any reorganization of banking powers involves a good many turfs, not just one. In these congressional wars, the more numerous and better financed battalions are not on the side of banking.

The second fact is that, generally Congress prefers to avoid doing anything when it comes to banking and the financial system. To be sure, there may be a few legislators who like to see financial issues stay alive and unresolved, thereby filling their campaign coffers, but most senators and representatives find that financial reform is essentially a "no win" issue when it comes to the folks back home. They prefer, therefore, if at all possible to delegate whatever power Congress should responsibly assume when it comes to financial reform. The delegation to the states of interstate banking authority is simply one illustration.

Can Congress ever be counted upon to act swiftly and responsibly? I suppose the answer must be yes, but I would say that the chances are far better whenever a crisis is looming—and even then it is not certain that Congress will move with great speed. Of all the papers I have heard here over the past several days, it is the Edwards paper that I would most like every congressman to have on his desk. And that is because his paper—although toned down to some extent in his oral presentation—paints a bleak picture of imminent disaster if reform is not accomplished rather quickly.

Another quite formidable roadblock to reform is the banking industry itself. I know that it is possible to paint, as Seidman's paper does for example, a rather gloomy picture of trends in bank profits, losses, declining market share, and the like, and to conclude that banks are as one in their desire to achieve reform. Perhaps so, but reform of the kind that we have been discussing here is, I am afraid, a rather low priority for many banking organizations, most probably for the majority.

We have a great many banks in this nation. If any one of you has been before a group of bankers recently—particularly community bankers or regional bankers—and discussed what globalization or securitization should mean to them, then you know, as I do, that your talk did not end with wild applause from the audience and demands for immediate action. In fact, the nonbank bank issue—an issue that, in the larger scheme of things, I regard as an irrelevancy—can generate more emotion among bankers in ten minutes than reform of the Glass-Steagall can generate in ten months.

The plain fact is that many banks are doing reasonably well, and a very large proportion of bankers are in a business with which they feel quite comfortable. They are generally aware that things are changing and that the future may not be all that bright. But this does not mean they are anxious to tear up the paving blocks and mount the barricades on behalf of reform.

Finally, there is one other impediment to reform that I hesitate to mention, given the wonderful hospitality that has been shown us here. Yet I do believe that the combination of monetary and regulatory powers in the Federal Reserve has meant that the Federal Reserve has been a significant barrier to reform in the past, and likely will continue to be one.

Obviously, I mean this in an institutional sense. I am not implying any malevolence on the part of Federal Reserve officials, whether at the Board or at the banks. And I am certainly not implying any lack of professionalism, or integrity, or concern for the public welfare —on all of these the Federal Reserve deserves the highest marks. Rather, it is because the Federal Reserve is in two different businesses —and those businesses do not mix.

One business, as I said, is the formulation and conduct of monetary policy, to which is attached "bank of last resort" powers. The other is the supervision and regulation of the expansion of banking organizations. The first, I believe, is the more important. Certainly it is a responsibility that must be exercised with the maximum degree of independence within government. But it is precisely that independence that is most threatened when the Board is forced to become embroiled in the political infighting characteristic of financial regulation. Consequently, and quite properly I might add, supervision and regulation takes a back seat.

What do I mean by "back seat"? For one thing, I mean caution, delay, and deference to Congress, even when Congress has clearly delegated responsibility to the Board of Governors, as it did in the case of powers that may be exercised by bank holding companies. Again, I am not trying to be critical. I am sure I would do the same thing if I were on the Federal Reserve Board. That is, when it comes to a question of roiling Congress up on regulatory issues, I would keep my head down and be certain to protect the far more important flank—maximum independence within government.

What we have had, therefore, is a classic "Catch 22" situation. Congress delegates to the Board; the Board defers to Congress.

Among historians, one of the more fascinating games, although perhaps not terribly productive, is the "what if?" game. Military historians in particular love to play it. In financial history we have our "what ifs?," many of which center on the Federal Reserve.

For example, "what if" the Federal Reserve Board some 15 years ago had not bowed to political realities in Congress and had held that the savings and loan business was not only closely related to banking but also was a "proper incident thereto"? Some interesting scenarios can be spun out from that one, given what has happened since. One, for which I could make a case, is that there would have been an orderly merger between the banking and thrift industries, that the present thrift/FSLIC problem would be much smaller, and in fact, that there might be no FSLIC today.

Another, even more intriguing "what if?" can be identified if we go back to 1969-70, when the Nixon administration, and most particularly the Treasury Department, labored valiantly to amend the Bank Holding Company Act to provide that its administration would be distributed among the three banking agencies. For example, bank holding companies with a preponderance of assets in national banks would be regulated by the Comptroller of the Currency, in state nonmember banks by the FDIC, and in state member banks by the Federal Reserve Board. That effort was beaten down in part because of the political astuteness of Chairman Arthur Burns, who managed to persuade Congress that the Federal Reserve really had no interest in regulating banks or much of anything else, but simply thought that it was the most experienced group when it came to determining the limits within which bank holding companies might expand. And so far as those limits were concerned, the chairman was prepared to suggest that the Board was thinking of being rather liberal, setting forth a menu that included, among other things, some interesting securities powers. That was 17 years ago.

But "what if" the Nixon administration had been successful? Even though the sought-after law required agreement of the three agencies, what might have happened if Section 4 of the Bank Holding

Company Act had been administered over the years by, say, a Jim Smith, a Tod Conover, or a Robert Clarke when it came to national bank holding companies, or by a William Isaac or a William Seidman when it came to nonmember bank holding companies? One can come up with a number of possibilities. My guess is that we would not be meeting here today, or at least we would not be meeting here on this particular issue.

In summary, the picture that I saw painted at this conference was one of rapid, almost bewildering, change in financial markets, pointing to a need for structural reform, the outlines for which are, generally, fairly well agreed upon. What gives me pause is: 1) that the ultimate rulemaker—Congress—is not very responsive, 2) that one of the major players—the banking industry—despite our holding out the glories of salvation does not exhibit any great desire to be saved, and 3) that one of the key regulatory agencies—the Federal Reserve—does not seem to recognize or agree with the proposition, implicit in so many of the structural reform proposals, that one of the essential elements for structural reform is its own demise as a regulatory agency.

Perhaps after all our future does indeed lie with the states. But given all of this, I regret even more that we never did hear the case for "muddling through."

Overview

Henry Kaufman

This symposium on "Restructuring the Financial System" is exceedingly timely. Extraordinary changes are taking place in the financial markets and Congress and regulators are slow in responding to these changes. Franklin Edwards was right, in his opening remarks, when he stated that "we must determine the financial system of the future, and put in place a compatible regulatory system." He then went on to say, we have "to agree on fundamental goals of financial regulation and on the amount of government intervention needed to achieve these goals."

I would express my concern more fervently. I feel very strongly that our financial system is going astray. Many deposit institutions are weak, and business and households have assumed massive debt burdens. This poses serious risks for our economy. In light of these risks, the current system of financial regulation is inadequate to deal with changes in financial markets. Congress should abandon the current system and pass comprehensive legislation to install a better one.

In designing a better regulatory environment, we must ask ourselves what kind of a financial system we really want. What should the financial institutions and markets try to achieve? How can this be accomplished effectively while safeguarding the public trust? Are there important distinguishing aspects between financial institutions and other private enterprises in the economy? In other words, we should begin setting forth a rationale for our financial system and then establish some of the tenets that will move us closer to an improved financial regulatory structure.

To begin, let me say that it would be impossible to run our complex and advanced economy effectively without integrated supportive activity from financial institutions and markets whose role is to intermediate the savings and investment process. Financial institutions and markets reconcile the needs of both the demanders and suppliers of funds. If we did not have an efficient financial system, the behavior of spending units and of savers would be severely limited and our economic performance would be sharply curtailed. Among other things, a well-functioning financial system should facilitate stable economic growth. In a broader sense, it should promote reasonable financial practices and curb excesses.

Some members of the financial and academic community make an important distinction among the underlying functions of the financial system. They divide the functions into two parts: to provide a mechanism through which flow all payments and to provide the framework through which allocating credit is efficient. This distinction is made because there is a clear need to safeguard the payments mechanism, but it is less clear that our system of credit allocation requires such safeguards. I believe, however, that in the financial world today, these functions are intertwined. The differences between money and credit are blurred. In an attitude that has changed markedly over the past few decades, borrowings are considered by many to be a source of liquidity and, therefore, a substitute for money or highly liquid assets. Short-term assets like Treasury bills and commercial paper are considered substitutes for money. Thus, the greater risks that may be inherent in today's credit structure are not reduced by paying special attention to safeguarding the payments mechanism, which once upon a time was a cash-only function. Moreover, other important financial changes have taken place that have affected the functioning of our financial system and that have often induced regulatory responses without full thought to the ultimate consequences. I will briefly mention five developments that need to be incorporated in plans to improve our financial system.

First, financial institutions today primarily acquire funds by bidding in the open market. This bidding for funds has been partly responsible for blurring the differences among financial institutions. A broad menu of obligations is available to temporary holders of funds and savers. Many are highly knowledgeable about these instruments and markets. Few institutions hold much in the way of "captive funds" at below market yields.

Second, institutions and other participants in the financial markets now actively engage in ‘‘spread banking”—an effort through which institutions try to lock in a rate of return that exceeds the cost of their liabilities. This practice began years ago as a commercial banking technique, but other institutions and businesses have followed suit with the creation of many new credit instruments ranging from floating-rate obligations to interest-rate and currency swaps.

Third, these spread banking and related opportunities were greatly enhanced through "securitization"—which, as is well-known, is the process by which a nonmarketable asset is turned into a marketable instrument. Today, many credit instruments have been securitized, including consumer credit obligations, mortgages, high-yield corporate bonds, and many derivative instruments, such as options and futures. They have enhanced the growth of the open market and inhibited the growth of the traditional banking market. Yet, many of these instruments, new as they are, are not completely understood and have yet to be tested in both bull and bear markets.

Fourth, financial institutions and markets are much more international in their activities. Funds flow from one country to another electronically with extraordinary volume, sometimes moving counter to underlying trade developments. Facilitating these international flows, large U.S. commercial banks and investments banks have built up great operations in key foreign money centers, and concurrently, foreign financial institutions are enjoying an increased presence in the United States. Today, many U.S. borrowers participate in both U.S. and foreign financial markets, and U.S. institutional investors are becoming more familiar with international opportunities. Again, the opportunity for reward has carried risk. Our money center banks' experience in lending to developing countries is one example. Managing the risk of floating exchange rates in a world of 24-hour-a-day trading is another.

Fifth, vast improvements in computer and communications technology are rendering many traditional institutional arrangements obsolete. Technological breakthroughs have a significant impact on the location of physical facilities, the communications linkages with clients, and the magnitude and speed of market decision making.

These changes, to a large extent, reflect the deregulation of interest rates without putting into place concurrently new prudential safeguards. In view of these developments, a number of issues need to be raised and resolved. One is whether financial institutions should be subject to special regulatory treatment. My answer is "yes." This is because financial institutions are entrusted with an extraordinary public responsibility. They have a fiduciary role as the holders of the public's temporary funds and savings. They generally have large liabilities (other people's money), a small capital base, and are involved in allocating the proceeds from these liabilities to numerous activities that are critical to the functioning of our economy.

If the role of the financial system carries a public or fiduciary responsibility, as I believe it does, then a governmental role in guiding the system is valid. No highly developed society has treated financial institutions and markets as strictly private activity, and Congress itself has long since recognized the role of central banking in guiding our financial system.

This distinction also hinges on the necessity for keeping the ownership of a financial enterprise separate from that of business and commercial activity. To combine the two would surely lead to economic and financial concentration, to major conflicts of interest, and to a compromise of the public responsibility of financial institutions. Equally important is that a marriage of business and the financial system would substantially widen the official financial safety net that is now extended only selectively to businesses and institutions when financial difficulties erupt. A mix of commerce and finance would spread the safety net to cover many private large enterprises. This, in turn, could lead to additional economic inefficiencies at the expense of small and medium-size enterprises that would suffer proportionately more in periods of economic distress. The result would be more economic and financial concentration.

Another question that needs to be addressed is whether financial institutions should experience the benefits and discomforts of monetary policy or should they be mere conduits that pass the full impact of policy on to households and businesses. In the past two decades, financial institutions have increasingly become conduits. Through spread banking and other techniques, for example, they have quickly passed on the higher cost of funds to local government, business, and household borrowers in order to protect their own profit margins. As a result, much higher interest rates have been required to achieve effective monetary restraint.

The final demanders of credit—such as consumers, businesses, and governments—have been encumbered with a higher interest cost structure. The ability of financial institutions to shift higher costs quickly has encouraged them to become more entrepreneurial and more aggressive as merchandisers of credit. Similarly, the securitization of credit obligations is probably loosening the traditional ties between creditor and debtor, adding to the entrepreneurial drive in the financial system.

The disquieting manifestations of this financial entrepreneurship abound today. Despite a sharp deterioration in the quality of credit reflected on the balance sheets of financial institutions, the drive to exploit growth through the continuing rapid creation of debt is very much alive. Banking institutions that are overloaded with the debt of financially weak developing countries are currently striving to extend credit to sectors in which debtors are still viable, such as households and businesses. The open credit market operates under the false assumption that marketability means high liquidity; it is exploiting the issuance of high-yield bonds and is taking on activities that are akin to bank lending practices. Financial market participants, however, will not escape from what has come about. The rapid growth of debt and its costs create a burden on households and businesses that is then, in turn, reflected back on the weaker and more marginal assets of our financial institutions; these institutions then become encumbered with inadequate capital and, consequently, experience pressures to improve profits by moving into other ventures. There is little solace when the deed has been done. By then, the financial system and its participants have been weakened.

In this context, the central bank operates precariously. It has to drive interest rates to hitherto unthinkably high levels when monetary policy restraint is required, because institutions have no vested interest in slowing credit availability early; it must also cut interest rates sharply once restraint is effective to avoid bankruptcies. The risk under this approach is that the central bank has to take on the role, increasingly, of lender of last resort to a wider range of financial and business participants. In essence, the recent changes in our financial system have facilitated the transfer of risk to the ultimate borrowers and investors. However, this has not eliminated risks from the system. Indeed, the process has contributed to a faster rate of debt creation, ultimately increasing the risks in the economy.

Financial institutions are not just the guardian of credit, but in a broader sense, they are also the mechanism that can either strengthen or weaken a market-based society. Financial institutions should be part of a process that encourages moderate growth of debt and substantial growth of equity and ownership. To be sure, to achieve such objectives, a correct fiscal and tax structure must be in place. Substantial risk taking and entrepreneurial zeal belongs properly in the world of commerce and trade, where large equity capital tends to reside, and not in financial institutions that are heavily endowed with other people's money. Encouraging increased leveraging of financial institutions automatically induces greater leverage in the private sector, making this area more vulnerable, more marginal and eventually inviting government intervention. The whole process thus undermines the essence of an economic democracy.

In this regard, there are a number of unalterable facts. First, when financial institutions act with excessive entrepreneurial zeal, the immediate outcome is a contribution to economic and financial exhilaration. Only later, when the loan cannot be repaid on time or the investment turns sour, are the debilitating and restrictive aspects of the excesses fully evident. In addition, official exhortations to limit the excesses of financial entrepreneurship are inadequate if not futile.

To some extent, our current regulations encourage risk-taking, because large institutions are not allowed to fail, and it is virtually impossible for major financial participants to remain uncompromised to some extent. As is clearly evident all about us today, the competitive pressure to be in the new mainstream of markets is intense. Growth aspirations are difficult to thwart once institutions set targets for profits, market penetration, and balance sheet size within a financial framework that prescribes no effective limits and that encourages, with great intensity, the application of financial ingenuity and liberal practices.

Thus, this issue comes down to'whether or not financial institutions should be a vehicle for sheltering households and businesses from becoming highly exposed financially. I believe that a bias in this more prudent direction would be quite desirable. In addition to the vulnerabilities that I have already mentioned, a less entrepreneurial financial system would reduce the wide gyrations in the financial markets, encourage longer-term investment decisions and focus society's efforts on meeting economic goals. As I will indicate later, this shift in financial direction is not yet beyond our reach.

Much of the debate on the reregulation versus the deregulation of financial institutions rests on just these issues. Do financial institutions serve an important public role, and in this role, should financial institutions protect households and businesses from financial excesses? The debate should not be decided solely on the basis of the so-called inequities in the marketplace today or on the premise that U.S. financial institutions should have sufficient flexibility to compete with rapidly growing financial institutions and markets in the United States and abroad. The resolution of the debate on these particular points will not necessarily strengthen our system. What others do may not be right. Indeed, if our banks had been inhibited in the past from competing so aggressively in the international arena, they would be stronger—not weaker—organizations.

However, if the Congress decides that a more deregulated financial system is preferred, at least two challenges will have to be met: How are institutions and markets to be disciplined? And, how will institutions have to be structured to compete on a level playing field? The disciplines of a deregulated financial system are simple in concept, but difficult—if not impossible—in reality, to accept, especially in a highly advanced economic society. Efficient institutions will amass profits and prosper, and inefficient ones will stumble and then fail.

The difficulty in accepting such disciplines reflects the fact that the failure of financial institutions involves other people's savings, along with temporary funds from the institutions in question and from other organizations linked to the financial institutions through the intermediation process. Moreover, such a deregulated system will surely burden households and businesses with an even greater overload of debt and make the economy more marginal. I hope that Congress will not move in this direction.

The obstacles to achieving a level playing field—a framework that would ensure competitive equality among the different types of institutions—are formidable. What kind of standards, if any, should institutions be required to adhere to? Can there be true competitive equality if the liabilities of some institutions are federally insured, while others are not? I doubt that deposit insurance can be eliminated from our financial system. If it were, market participants would assume that the official safety net would cover an even larger portfolio of the financial system until a major institution is allowed to fail, and then the risks of contraction in the financial system and economy would be extremely high. It is the type of risk that we, as a society, should avoid.

Now, much was said in the last two days of our discussions about the role of the commercial banks and the broader powers that should be accorded to them. However, in restructuring the financial system, we cannot overlook the many changes that have occurred in the open credit market, both here and abroad. Robert Eisenbeis spoke about the changes in clearing arrangements. On the whole, very little was said about the huge growth in open market transactions, in derivative credit instruments, about the credit exposures in the various clearing mechanisms, about the potential settlement problems, and the extraordinary capacity to speculate in this financial world as compared with the more limited aggressive financial activity a few decades ago.

In formulating the groundwork for an improved financial system, we cannot and should not return to the compartmentalized structure that prevailed years ago. Financial life is evolving, and we should be able to retain the best and discard undesirable aspects of this process of change. To ignore the developments in our financial world will invite the risk of substantial disarray. Those who favor further substantial deregulation do so on the grounds that such a system, by being highly competitive, will provide services at the lowest cost. They ignore both the special fiduciary role of institutions and the fact that the costs of service delivery are only one aspect in judging the performance of the financial system. They also fail to recognize the consequences of allowing failures to be the sole disciplining force in this system.

Advocates of substantial deregulation, however, do not agree when it comes to deposit insurance. Large institutions often favor the removal of insurance altogether or insurance fees associated with the risks involved in the insured institution. The assumption here is that large institutions will have an advantage, because even in a fully deregulated environment, the government would be much more hesitant to allow such institutions to fail. The likely consequence would be increased financial concentration. Deposit insurance based on the associated risks would probably also not work well, because higher fees would boost the costs of already marginal institutions, promote enlarged risk taking to offset these costs and put depositors clearly on notice that they are maintaining accounts with a vulnerable institution where deposit insurance may not hold.

Many advocates of regulation want to maintain the status quo. This position, I believe, is completely unrealistic. Adherents to this view fail to acknowledge some of the important changes that I mentioned earlier: the aggressive bidding for funds by institutions, the globalization and securitization of markets, and the quick pass-through of costs by institutions to final demanders of credit. Only a few have called for some sort of new regulation. For example, E. Gerald Corrigan, president of the Federal Reserve Bank of New York, has put forth a well-reasoned and articulate set of proposals for reforming the financial structure. On the whole, he emphasizes arranging the institutions in our system into three groups: bank and thrift holding companies; financial holding companies; and commercial and financial conglomerates. I believe that this arrangement is influenced by his central banking responsibility. He wants to ensure that the central bank, as the lender of last resort, can function effectively in crisis periods.

Corrigan's analysis stresses having a well-functioning payments system, and he has argued persuasively for keeping commerce apart from banking. But as I stated earlier, the blurring of the distinction between money and credit means that safeguarding the payments mechanism is only one part of an improved financial regulatory structure.

What then should be done to establish a reformed financial system that recognizes the changes that have occurred and concurrently provides the underpinnings to encourage stable economic growth and provide for the general wellbeing of an economic democracy? I suggest the following.

First, an official central authority should be established to oversee all major financial institutions and markets. Today, we live in a highly integrated financial system in which, as I noted earlier, institutions bid for funds and, in some instances, carry on comparable activities in the allocation of these funds. The current system of diverse and overlapping official supervision lacks a coherent overview and fails to meet the realities of the financial world today. This new central authority should also establish minimum capital requirements and uniform reporting standards, and it should require much greater disclosure of the profitability and balance sheet data of our institutions. When monetary restraint is required, this new centralized authority should increase the minimum capital of financial institutions. In this way, institutions would be restrained, and households and businesses would be less encumbered financially. The reverse would, of course, hold when monetary ease is needed. Capital requirements based on the riskiness of assets is a step in the right direction. This authority should also set a time schedule that would require all institutions to report their asset values at the lower of cost or market. Such a requirement would further inhibit the weakening of our financial institutions.

Second; an official international authority should be established to oversee major financial institutions and markets, regardless of their location. Its membership should consist of representatives from the major industrial nations. As noted earlier, global financial institutions and markets exist today—a fact that makes the supervision of institutions and markets by national authorities ineffective. Borrowers and institutions quickly arbitrage the regulatory capital requirements and other differences between one financial center and another. At times, the agility of market participants limits the policy effectiveness of central banks. Consider, for example, how easy it is for participants who have access to international financial markets to circumvent the policy objectives of central banks or how much more forcefully others have to be constrained in order for monetary policy restraint to achieve its objective in tightening markets. Such an official international authority should set minimum capital and reporting standards for all major institutions that operate internationally, and uniform trading practices and standards should be established for participants in open market activities.

Third, because conflicts of interest run the serious risk of undermining the efficient functioning of the financial system and the economy, they must be avoided. There are three activities that need to be kept apart: lending, underwriting of securities, and equity investing. Conflicts of interest are bound to arise if these activities are joined.

With these conflicts of interest in mind, the following principles should underlie new financial regulations.

First, commercial and financial institutions belong apart.

Second, financial institutions should not be allowed to be both lenders and equity investors. The system of regulation should force financial institutions in their dealings with the business sector to choose whether to be an underwriter, a lender, or an equity investor.

Finally, deposit insurance should be used to strengthen the financial system—and not serve only as a guarantee of the safety of deposits. The proceeds from all insured deposits should be required to be invested either in high-grade securities or loans that are deemed to be highly creditworthy by the official regulators. If deposit institutions prefer to make lower quality loans and investments, they should be booked in another institution and financed with noninsured funds.

There are no easy and quick solutions to the problems that now permeate our financial system. The comprehensive review that Congress is undertaking currently is a welcome prerequisite for formulating a new and improved structure. Your investigation should focus not on how quickly the last vestiges of the Glass-Steagall Act can be removed, but rather, the issue before Congress should be "If not Glass-Steagall, then what?" A fully deregulated financial system is not the solution. Financial institutions have a unique public responsibility. Consequently, a better regulated financial system that incorporates the many changes that have taken place in the past few decades is, in my opinion, the correct way. This will position financial institutions and markets to facilitate economic growth instead of contributing to substantial economic turbulence in the future.

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