

# The Case for Preserving Regulatory Distinctions

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*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, indivisibilities 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 of 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 portfolios 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 intrinsically 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.

## References

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