Banking Deregulation—Where Do We Go From Here?

Earlier this month, we witnessed a chaotic winding up of the Congressional session, with action on only those bills for which there was a compelling need and a reasonable prospect for passage Among the many casualties was a generally constructive banking bill, which had been passed by an overwhelming majority in the Senate As a result, we are left with a familiar sense of frustration and uncertainty over the outlook for further reforms to the nation's banking laws

Why has it proven so difficult to reach a consensus on banking legislation? One problem, of course, is the very divisive nature of the competing private sector interests in the particulars of any such legislation But that is certainly not new What stalled legislation this time was an unusual degree of disagreement on three broad points The first is the readiness of our financial institutions to cope with another wave of more intense competition Specifically, is our financial system strong enough to continue with deregulation? The second relates to priorities for further change Namely, which new powers, how to deal with interstate banking, and how much scope should be given to state governments on these issues The third concerns how best to provide discipline and safeguards against imprudent behavior in a less regulated financial system

Certainly, these are complex issues, where strong differences of view are to be expected Many involve controversy over protected turf, making them even more difficult to resolve But it is a serious mistake to think we can afford an extended period of legislative inaction, in the face of rapid change in our financial system. So a consensus must be reached on these broad points Let's consider the key issues

The fact that there are Congressional concerns over the readiness of our financial institutions to adapt to further deregulation is understandable enough After all, the debate over banking reform has been against a financial background that has been anything but calm The problems in the industry have been well publicized. the weaknesses in LDC loans, high failure rates among banks and thrifts, the deterioration in energy credits, the debacles of Drysdale and Penn Square and, most recently, the downfall of Continental Illinois. Each of these problems hit the financial system with force, triggering shock waves that threatened to cause further distress The net result has been nagging fears that our depository institutions have become too risk-prone for their own good, and that the safety nets which protect depositors and backstop these institutions have encouraged risk taking, by bailing out problem banks and thrifts

Despite all the turmoil caused by these shocks, our financial markets have shown considerable resiliency And the authorities have demonstrated both a capacity and willingness to contain the fallout from them, generally in ways which have imposed costs on those most responsible for the problems There also are a number of positive signs indicative of efforts to further strengthen the system

For one, nonperforming loan ratios at the major U.S. banks are still lower, and problem sectors less widespread, than in the mid-1970s, when banks were hurt

Remarks of Anthony M Solomon President of the Federal Reserve Bank of New York, at the National Bankers Association on Wednesday October 17 1984

by REIT loans and the fallout from that severe recession It is true, of course, that these ratios generally don't reflect large portions of restructured debt to Latin American governments But it is also true that very considerable progress has been made toward a constructive, long-term approach for dealing with the LDC debt problem Indeed, despite some remaining trouble spots, there is a better overall tone to debt renegotiations than at anytime in the past two years

What stalled legislation was disagreement on three broad points: the readiness of our financial institutions to cope with another wave of more intense competition; priorities for further change; and how best to provide discipline and safeguards against imprudent behavior.

Moreover, virtually all major U S banks have significantly bolstered their capital positions, including their loan loss reserves In the process, bankers have recently shown an increased willingness to face up to the problems in their portfolios and to take remedial actions And in the one area in which deregulation has been very extensive—that is, rate deregulation—most banks have adapted very well to the transition to more aggressive competition

Still, there are some disturbing signs which can't be ignored Although nearly two years into the recovery, we have yet to detect clear indications of a long-awaited improvement in bank asset quality Instead, the key indicators show continued slippage There is also growing unease with the risks banks have taken on through creative lending arrangements, such as in leveraged buyouts Moreover, nonfinancial corporations have been increasing their reliance on short-term debt to new record levels And, there is still a long road to recovery for the major debtor nations So, the banking industry has a greater than normal stake in the U S achieving continued steady economic growth and declining interest rates

But difficulties haven't been confined to banks Major players in the insurance and securities sectors have also had their share of performance problems The more intense competitive pressures have taken a toll on margins in these businesses, just as in banking As a result, there is now less room for error in management decisions to expand product lines or enter new markets Moreover, conditions in the thrift industry remain very weak, with some form of continued Federal capital assistance for the thrifts inevitable

Finally, there is the disturbing evidence of the Continental Illinois case, where the initial assurance from the FDIC proved insufficient to stem the deposit flight This sent a chilling message Namely, once funding fears develop, not only does management have very limited options to contain the problem, but so do the authorities This fact, together with the heavy dependence of some major U S banks on volatile funding sources, has contributed to a perception of financial vulnerability at this time

From the standpoint of public policy, these developments offer ample reason to place extra weight on safety considerations when evaluating various paths along which to channel further changes in our financial system And they underscore the need to upgrade financial standards to ensure that our institutions can deal with unforeseen problems, especially during what could be a difficult transition period But, in my opinion, they do not warrant closing off avenues for further change in our financial system Indeed, that is not even a realistic option

The fact is the blurring of distinctions among commercial banks, thrifts, securities firms, and insurance companies is unleashing waves of new competition These waves are swamping a regulatory structure designed to preserve comfortable distinctions among them As a result, the nation's banking and securities laws have become constant targets for evasion Various states are also trying to outdo one another in efforts to attract new jobs via liberalized banking laws And our financial landscape is becoming cluttered with products and institutions that have been contrived to exploit regulatory loop holes The most offensive example is the so-called "nonbank bank", which can be used by any type of firm to provide banking services anywhere in the country These trends rule out a stand pat approach to banking legislation Congress has recognized the need for a new base on which to build future financial change, but has been stymied on the question of the priorities

The legislative framework should rest on four legs: a reaffirmation of the boundary between banking and commerce; a selective expansion of financial powers for banking organizations; a phase-in of nationwide banking; and a reasonable set of limits on the authority of states to experiment with new banking powers.

As I see it, that legislative base should rest on four legs a reaffirmation of the boundary between banking and commerce, a selective expansion of financial powers for banking organizations, a phase-in of nationwide banking, and a reasonable set of limits on

the authority of states to experiment with new banking powers Let me focus on the powers and interstate banking issues

Few would argue against the desirability of limiting our banking organizations to activities of a financial nature and of prohibiting nonfinancial firms from operating banks. What is more controversial is to determine where, along the spectrum of financial activities, a line should be redrawn to separate depository institutions, on the one hand, from securities firms and insurance companies, on the other Not everyone agrees that a continued separation is necessary today For example, the more aggressive bankers maintain that banks today enjoy no unique advantage over other profit making financial firms They argue that banks should not be restricted from offering as full a range of financial services as can be provided by some of their nonbank financial competitors.

Regarding the line between banking and other financial services I would suggest three guiding principles: new activities should represent natural extensions of the types of financial services banks now provide to household and corporate customers; they must be acceptable from the standpoint of prudential and conflict of interest concerns; and they should contribute to the banking industry's need to broaden earnings capacity through new services.

From a strictly competitive standpoint, this argument is not without merit Nonetheless, if you believe that depository institutions play a special role in our financial system, and that there is a strong public interest in maintaining a sound banking system, then you cannot simply dismiss the need to retain some separation Yet you must also ask how long banks can afford to be special, if that means laboring under extensive competitive restraints

There are many practical difficulties in determining where, in today's economic world, one should redraw the line between banking and other financial services. In fact, given the speed with which changes are taking place in our financial system, I don't consider it desirable to be too rigid or precise in setting new boundaries So rather than dwell on details, let's consider, in broad terms, what would be a logical basis on which to draw such a line, if one were starting with a clean slate. In so doing, I would suggest three guiding principles new activities should represent natural extensions of the types of financial services banks now provide to household and corporate customers, they must be acceptable from the standpoint of prudential and conflict of interest concerns, and they should contribute to the banking industry's need to broaden earnings capacity through new services

When viewed on this basis, there's little reason to prevent banking organizations from offering the household sector brokerage, agency, and advisory services for securities, insurance, and perhaps real estate needs What limited concerns these raise, in terms of potential conflicts of interest, hardly seem to warrant outright prohibitions on bank entry Nor would such offerings to individual consumers have to be through affiliated companies In some instances, franchise or agency relationships may provide a sufficient foothold Moreover, there is also a basis for allowing banks to offer consumers a full line of insurance and securities services, since the level of risks associated with providing these services to households is generally quite manageable.

The more difficult judgments arise in the case of financial services for corporate and other institutional customers Certainly, there are significant risks associated with corporate securities underwriting, commercial risk insurance, and real estate investment And there are also more apparent opportunities for conflicts of interest to develop between the role of commercial lender and that of equity investor or underwriter At the same time, many types of securities underwriting, including commercial paper, municipal revenue bonds and mortgage backed securities, are obviously very closely related to what banks now do, and without noticeable problems in terms of excessive exposure to risk or conflict situations And there are also close business connections between real estate financing services banks now provide and the authority to take passive equity positions in those same projects, as is often done by their insurance company competitors

On balance, I would conclude that these concerns warrant significant prudential limitations on bank involvement in real estate investment activities, and, in the case of corporate securities underwriting, continued exclusion, at least for the present As more experience is gained through selective expansions into related areas of securities underwriting, the need for such prohibitions can always be reassessed

In sum, this suggests broad latitude for expanding banking powers at both the retail and wholesale level In time, that may well be how our financial system evolves But it is unlikely to get there anytime soon, since Congress appears to have a far more selective appetite for expanded bank powers And where it has shown such an appetite, it has typically been based on more concrete linkages between those new powers and expected public benefits, as for example, the type of benefits which would flow to municipalities and the

housing sector by broadening the market for revenue bonds and mortgage backed securities. I suspect it will take similar concrete linkages to consumer and community benefits in order to achieve a more significant expansion of banking powers

Public policy concerns require a Federally sanctioned approach to interstate banking that is free from permanent regional restrictions and that provides upfront for an orderly transition to full nationwide banking.

The other major point of controversy on which a consensus needs to be reached is the issue of nationwide banking. It is encouraging to see that this issue, which for too long has taken a back seat to the powers question, has finally moved to the forefront on many legislative agendas. Still, Congress seems inclined to toss the issue back to the states, where there is a ground swell of interest in forming regionally restrictive compacts. The hallmark of all such compacts is that they exclude those states which are home to the nation's largest banks

There may be some scope for considering regional banking arrangements as a limited transitional device to a broader form of nationwide banking. However, we should not ignore the dangers of these restrictive agreements, particularly among participants who are unwilling to build in provisions for an eventual opening of their markets Once compacts are established, the larger banking organizations that form in the regions will have little incentive to consider permitting new competition They could well grow dependent on continued protection, to the detriment of the markets they serve. Nor should we expect the uninvited outsiders to be idle observers as the nation's more attractive markets are parceled out. Instead, the likely response would be renewed efforts to exploit ways to evade restrictive state laws and to concentrate nonbank expansion in these same markets This will lead to counter actions to further limit available entry vehicles. The net result is bound to be extensive litigation, the beginnings of which have already surfaced, and a misallocation of capital and managerial resources as competing banks jockey for position

I believe public policy concerns require a Federally sanctioned approach to interstate banking that is free from permanent regional restrictions and that provides upfront for an orderly transition to full nationwide banking. The transition period would allow efficient community and regional banks to strengthen themselves in the local markets which they serve. There can also be safeguards put in place to ensure that banks which embark on expansion programs have the needed financial and managerial depth.

I'm well aware that the prospect of interstate banking has long been viewed by many independent, community banks as a threat to their future. Many felt much the same way about the prospect of statewide branching. Yet, the evidence in New York, California and elsewhere showed that well-run community banks can compete very effectively alongside money center organizations. And, if anything, when large banks enter into new states it will be focused on markets in population centers, presently served by the larger regional banks, rather than the community organizations. So I don't view interstate banking as posing a significant threat to the role of community bankers in local markets

The final broad policy issue on which I'd like to touch is how to maintain discipline within our banking system in a less regulated financial environment.

Some would have us believe that we can rely to a much greater extent than presently on what is loosely described as "market discipline" to keep banking institutions strong What does this entail? Market discipline is administered through price differentials on bank liabilities and equity and, ultimately, through an unwillingness to provide funding. It depends on the ability of market participants to detect and price differences in risk; on the responsiveness of bank management to early signals of market concern, and, ultimately, on the willingness of regulators to countenance the failure and liquidation of banks. To rely more heavily on this type of discipline would require even broader market access to detailed information about a bank's condition. And a further, logical extension would be to cut back significantly on the extensive Federal insurance protection now provided to bank depositors

The overriding concern with heavy reliance on market discipline, is that it will lead to further instability in our financial system. So while market discipline should continue to play a significant role in our system, I see it as one which reinforces, rather than replaces, the discipline imposed through regulatory and supervisory standards.

Even then there would be no assurances that market responses to signs of bank weakness would come early enough to promote corrective action. Instead, it could merely exacerbate problems by creating funding strains. Thus, the overriding concern with heavy reliance on market discipline, particularly when exerted through

pressure from uninsured depositors, is that it will lead to further instability in our financial system So while market discipline should continue to play a significant role in our system, I see it as one which reinforces, rather than replaces, the discipline imposed through regulatory and supervisory standards How can those standards be maintained and strengthened?

To begin with, certain minimum safeguards must be a necessary condition for expanded banking powers or interstate banking. These include authority for regulators to prescribe prudential limitations for the conduct of new activities, to review expansion proposals to ensure they are supported by adequate financial and managerial resources, and to retain authority to supervise all aspects of bank holding company operations

There is also a need to strengthen regulatory discipline This might include selective reforms to the deposit insurance system, involving controls on the use of brokered deposits and perhaps the use of risk sensitive premiums What could be more helpful would be devising benchmarks for relating our higher capital adequacy standards to risks being managed, both on and off the balance sheet Still, these are, at best, only useful tools And, in the case of higher capital standards, we must keep in mind that, if they can't be supported by quality earnings to attract new capital, they can become self-defeating.

In the final analysis, less formal regulation will require strengthening the supervisory process For one, the discipline of liquidity management needs to receive more attention Recent experiences have dramatized the importance of keeping business plans consistent with sustainable funding strategies In those cases where funding depends on heavy use of potentially volatile sources, much closer links need to be established between a bank's funding practices and the maintenance of high standards of financial strength Ideally, those links should be established by banks themselves and then reinforced by the supervisors and marketplace

Also, old lessons on the importance of portfolio diversification and on resisting temptations to reach for earnings through creative stretching of credit standards, need to be relearned. Supervisors can reinforce this through clearer standards for determining what constitutes excessive concentrations in a bank's portfolio.

The supervisors must also be prepared to move earlier and more forcefully to bring about corrective action, especially at larger banks where weakness can pose risks to the overall system. The lack of forceful follow-up has been a recurring criticism of the supervisory process Tendencies to defer to management on how to respond to points of supervisory criticism, or to be guarded in the signals sent to a bank's board until problems become self-evident, will have to be overcome

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Finally, bank supervisors at both the Federal and state level must ensure that their respective standards aren't reduced to a least common denominator. This is especially important in terms of state bank supervisors They now are under pressure to help attract new jobs into their states through liberal banking regulations and to assume greater responsibility for supervision of state chartered banks, yet still respond to local budgetary pressures This is not a particularly healthy combination of pressures at a time of strains and rapid changes in our financial system. Nor are all state banking departments as well equipped as ours here in New York to respond to these pressures We in the Federal Reserve are prepared to work closely with the states to help strengthen their respective banking departments.

What all this adds up to is an unusually complex and imposing agenda for the regulators and for the next Congress From the regulators, you can expect a steady flow of policy initiatives designed to shore up financial standards in the industry From Congress, I think you should expect significant Federal banking legislation, since it is clear that failure to act will trigger frantic efforts to exploit the numerous existing loopholes. There is little point in speculating on the likely particulars of such legislation But it will have to deal with the broad issues touched on today. How they are resolved will have an important bearing on the future structure of the financial system in which you operate, even if it doesn't have an immediate effect on the special role you play in your local markets