Legislative Priorities

Mr. Chairman and Members of the Committee. I am pleased to have this opportunity to appear before you this morning. The issues raised in your letter of invitation are of great importance now and well into the future. Not surprisingly, they are also exceedingly complex and do not lend themselves to a simple synopsis in the form of an opening statement. Therefore, I would propose to confine my prepared statement to an overview of the key priorities facing the Committee as I see them. However, I have appended to this statement several earlier public statements of mine—together with some statistical materials—that relate to the subject matter at hand, and I would ask that they be included in the record.

At the risk of an obvious oversimplification, I believe the issues before the Committee in seeking to shape its agenda can be viewed in the context of four central priorities, and my statement will proceed accordingly In speaking to these issues, Mr. Chairman, I want to convey a sense of urgency, which is rooted in my conviction that failure to come to grips with these matters in a prompt and progressive fashion entails unacceptably high risks of major difficulties at some later date. I also want to be clear that the views I will express today are my own and should not be attributed to the Federal Reserve Board or the Federal Reserve more generally. Let me now turn to the four priorities.

The *first* and most important is that we, as a nation, must get on with the very pressing task of narrowing and eliminating the very large and persistent macroeconomic imbalances that, in my view, constitute a major threat to our economic and financial well-being over time. By macroeconomic imbalances I mean, of course, the sizable and inexorably interrelated gaps between what we import and what we export, between what we consume and what we produce, and between what we save and what we invest.

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Most would accept at face value the importance of eliminating these imbalances over time, but some might ask why it is so important in the specific context of the well-being of our financial markets and institutions, including their international competitiveness. As I see it, there is a very direct connection between these macroeconomic imbalances and the issues immediately before the Committee

I say that for the following reasons. First, there is no question in my mind that the current imbalances in the U.S. and the global economy contribute importantly to the volatility we see in financial markets. This volatility can be the source of dangerous elements of risk—including systemic risk—to financial institutions and

Statement by E Gerald Corrigan, President of the Federal Reserve Bank of New York, before the United States Senate Committee on Banking, Housing, and Urban Affairs on Thursday, July 13, 1989 The attachments referred to in this statement are not reprinted here markets. Second, as long as the budget deficit is so very large relative to domestic savings, we are, in effect, hostage to the willingness of foreigners to plug our savings gap at interest rates and exchange rates that are otherwise compatible with satisfactory overall economic and financial performance Right now that

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process is proceeding in a relatively easy and painless fashion, but it has not always been that way. More to the point, there is absolutely no guarantee that it will stay that way in the future. Third, the high private savings rates and large current account surpluses in a number of other countries are a major factor contributing to the increased importance and enhanced competitive position of their financial markets and their financial institutions

Finally, I am convinced that a major factor in explaining the high cost of capital in the United States relative to Japan and Germany is to be found in patterns of macroeconomic performance here in the United States. Needless to say, those differences in the relative cost of capital have very important implications for the well-being and competitiveness of U.S business enterprises, financial and nonfinancial alike.

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Let me elaborate briefly on this latter point. There is a widespread perception that the cost of capital in this country is higher than it is in Japan and Germany and that these differences are importantly related to tax rate and/or tax structure considerations. Based on work we have been doing at the Federal Reserve Bank of New York, it appears that the cost of capital in the United States is indeed high, but tax considerations are not the principal explanation. More specifically, the pronounced difference in the cost of capital seems to be importantly rooted in (1) differences in private savings rates and (2) higher risk premiums in the United States due to (a) greater volatility in macroeconomic performance and (b) higher and more volatile rates of inflation. This is not to say that other factors—including tax considerations—do not matter in explaining differences in the cost of capital. But it does suggest that the emphasis that is often placed on tax policy as the major or dominant factor in explaining these differences is misplaced. As always, at the end of the day it is the economic fundamentals that really matter

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My *second* priority relates more directly to matters within the purview of this Committee. That second priority is the compelling need to proceed with the prompt, progressive, and comprehensive overhaul of the basic structure of our banking and financial system. The Committee is familiar with my views on this subject as set forth in my January 1987 essay on *Financial Market Structure: A Longer View*. Earlier this year, in addresses before the New York State Bankers Association and the Institute of International Bankers, I attempted to take stock of the progress that has been made in moving toward a more coherent, a more competitive, and a more stable banking and financial system over the past two or so years. My conclusion, unfortunately, was that on balance we had not made much progress, and from an international perspective we probably had lost ground.

The main thrust of my own thinking on this subject has not changed materially since my 1987 appearances before this Committee. For example, I still believe that the guiding principles and broad approach to reform outlined in my 1987 essay remain essentially valid today. Similarly, I remain of the view that structural reform of the banking and financial system must be accompanied with adaptations and enhancements of the supervisory process—a subject I will turn to shortly. Finally, I remain convinced that sound public policy demands that we strongly resist structural arrangements—whether they materialize by design or by accident—that would permit banking institutions having access to the public safety net to be owned and controlled by commercial concerns. If anything, recent developments—including experience with segments of the thrift industry — have reinforced my belief in that regard The reasons why I have such strong views on this subject are outlined in an excerpt from my June 1987 statement before this Committee, which is also appended to this statement.

While the broad thrust of my thinking about structural reform of the financial system has not changed, my sense of urgency about the task has grown. The reasons for this are rooted in market developments here and abroad, which in turn have important implications for (1) the competitive position of U S. firms and U S. markets and (2) the manner in which we and others seek to formulate effective supervisory and prudential policies. Looking around the globe, it is quite clear — especially in wholesale banking and financial markets — that the interrelated forces of technology and financial innovation are rendering segmented financial systems, such as we have in the United States, increasingly obsolete. Indeed, in virtually all other major industrialized countries the clear trend is toward more integrated financial institutions, with elements of commercial banking, securities activities, investment banking and, to a limited but growing extent, insurance activities coming under common ownership and control The only major exceptions to this trend are in the United States and Japan, but even in Japan serious consideration is now being given to the substantial liberalization of Article 65 — the Japanese version of Glass-Steagall.

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As all of this occurs, not only do we run the very troubling risk of losing competitiveness — including the loss of jobs, income, and tax revenues in our major financial centers such as New York, Chicago, and San Francisco — but we also run the risk of fostering unnecessary and potentially dangerous political tensions concerning the rights and privileges of institutions to operate freely in foreign markets. For example, while I am clearly encouraged by the recent steps taken in Brussels to respond constructively to expressed concerns about the reciprocity provisions in the European Community banking directive, I am certain that difficult problems lie ahead in this area so long as the basic structure of our system is so different from most others

This is not to suggest that we — or any other nation — should compromise basic national goals and priorities in the name of a "cookie cutter" approach to financial structure dictated by international considerations. That would be neither desirable nor appropriate. On the other hand, it would be equally undesirable and inappropriate to ignore developments in the global marketplace that have a direct impact on the prospective well-being of our financial markets and institutions. We can and must adapt our system in ways that are broadly sensitive to market developments while still consistent with our own national priorities, traditions, and culture.

My *third* priority relates to efforts to further modify supervisory approaches and the so-called safety net more generally to the needs of the day and beyond. At the heart of this issue is, of course, the very delicate balance between the dictates of a competitive, efficient, and market-driven financial system on the one hand and the preservation of a safe, sound, and stable system on the other

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In approaching this task, we must keep in mind an important practical constraint namely, it is impossible to conceive of an effective and durable approach to the restructuring of supervisory responsibilities among the various agencies unless and until we have come to grips with reform of the basic structure of the financial system itself. While the specific task of reshaping the structural approach to banking and financial supervision must, therefore, go onto the back burner, we do need a vision of what is important as we fashion policies in the interim and as we seek to adapt our attitudes to the needs of that broader and longer term goal. Several things strike me as important in this regard. They are:

- First, in my judgment we should operate on the assumption that systemic risk considerations are even more important than they once were, if only by virtue of the volume, speed, and complexity of financial transactions and the related far-reaching operational, liquidity, and credit interdependencies between financial markets and institutions nationally and internationally. The fact that monetary policy now works mainly through interest rate and exchange rate channels — as distinct from de facto credit-rationing devices — only reinforces my belief in this regard.

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- Second, very strong capital positions for individual institutions — especially major institutions — are an absolute must. To put it bluntly, there is no banking system, no supervisory system, nor any safety net that can compensate for weakly capitalized financial institutions except at major costs to society at large. Stated differently, we simply cannot tolerate a system in which the incentives work to maximize profits and socialize losses.

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- Third, the Federal Reserve, as the nation's central bank, must remain a prominent part of the supervisory process I raise that subject today because every now and then I hear the suggestion that the Federal Reserve should confine itself to monetary policy and leave the supervisory business to others. I also raise the subject gingerly because I know full well that there are those who will react to my statement by suggesting that it is motivated by turf or institutional self-interest considerations. For those who are inclined to that view I suspect there is nothing I can say that will change their minds. What I can say, however, is that from my perspective the relationships and the linkages between monetary policy and financial stability are profoundly important and ultimately inseparable. Moreover, if the Congress and the public at large expect that the Federal Reserve will continue to play a constructive role in helping to cope with financial problems when they arise, the Fed must continue to retain the tools, including on-site examination authority, necessary to do that job well.

Our system of official oversight must be predicated on the principle of consolidated supervision, including supervisory oversight of holding companies.

- Fourth, our system of official oversight must be predicated on the principle of consolidated supervision, including supervisory oversight of holding companies. This is a well-established principle on a global basis as it pertains to banking institutions. However, here in the United States and to a degree elsewhere, that principle is not followed for securities firms and investment banks. Moreover, there are those who would view firewalls as a substitute for consolidated official oversight. I simply do not share that view. Therefore, I believe we must — for both competitive and prudential reasons — clarify our thinking on the subject of firewalls and corporate separateness.

  As the Committee knows, I have always taken the view that firewalls can serve a useful and necessary purpose. They help protect against unfair competitive practices, they help guard against conflicts of interest; they help protect the integrity of the deposit insurance system and the safety net more generally, and they help to facilitate a system of functional supervision. Having said that, I have also consistently maintained that in practice, when the temperature goes up, the firewalls tend to melt. I have further maintained that insofar as the marketplace is concerned, in times of stress, firewalls become something of a fiction. Never was that more clear than at the time of the October 1987 market break. In that setting, when questions arose in the marketplace both here and abroad about the creditworthiness of individual firms, those questions pertained to the company as a whole, with almost total disregard for the niceties of corporate structure.

  If that is a reasonable description of the realities of the marketplace, then it seems to me to follow that we must be prepared to think about two possibilities that lie well outside the bounds of conventional thinking in this country. One possibility is that we try to recondition attitudes in the marketplace to accept a legalistic view of absolute corporate separateness. That, however, strikes me as wholly impractical, especially since it would have to be achieved on a global basis to be effective. Indeed, leaving aside completely the question whether CEOs and boards of directors are prepared to accept this view of the world, I know for a fact that authorities in many other countries simply do not look at things in this manner.

The other possibility is that maybe—just maybe—we have to begin thinking in terms of something that leans in the direction of the so-called universal bank model. Having said that, let me hasten to add that I'm not stating a conclusion. But I would be less than candid if I did not acknowledge that I now give this possibility more serious thought than I once did.

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That brings me to another controversial subject. Namely, of all the public policy considerations relating to the operation of the banking and financial system, the greatest concern is that of systemic disruption or failure. Having said that, let me now say quite directly something I have hinted at in the past. That is, the potential systemic damage growing out of the sudden and uncontrolled failure of a large, globally active nonbank financial firm can be just as great, if not greater, than the damage that can arise from the demise of a large, globally active banking firm. Indeed, this can be true even for some smaller firms. However problematic that view may be, it is, in my judgment, the reality. In turn, it is one of the reasons why I believe that the principle of consolidated supervision—which, among other things, fosters centralized systems of risk control and management—is so important. More generally, the systemic risk phenomenon also needs to be taken into consideration in the context of the national debate on financial structure.

In closing, Mr. Chairman, I have a *fourth* priority I want to comment on very briefly with a view toward getting the subject on the table rather than offering any hard suggestions. That fourth priority is that we do all we can to move more fully and more forcefully in the direction of greater coordination and harmonization of supervisory and prudential policies both domestically and internationally.

This call for greater harmonization obviously applies to the basics of financial structure as well as to central elements of prudential policies such as capital standards. But it applies in other areas as well. For example, I place great importance on what I call the "plumbing" of the financial system—the day-to-day, hour-by-hour, and minute-by-minute workings of payment, clearance, and settlement systems. While it is not fundamentally a legislative matter, seeking to extend efforts aimed at coordination and harmonization to encompass operational policies and practices that relate to key elements of the "plumbing" of the system strikes me as an important objective in its own right. Over the past several years—perhaps especially in the post-stock-market-break interval—we have seen major gains in this regard. And still other initiatives in both the public and private sector are under way.

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Much is at stake, not only for our financial institutions and markets but for our national well-being more generally. The longer we fail to forge a coherent approach to these problems, the greater the danger that we will find ourselves scrambling for ad hoc solutions in a less hospitable environment than we face today.

However, in all of this, we are trying to hit a very rapidly moving target in a setting in which the risks of competition in laxity and regulatory arbitrage, nationally and internationally, are very real. To cite an illustration, if we take a fairly straightforward activity such as foreign exchange trading in New York and London, there are at least five different regimes of capital and prudential standards that apply to that single activity depending on whether the firm in question is a bank, a merchant bank, an investment bank, a branch of one of the above, or a subsidiary of one of the above. Of course, if we put into the equation foreign exchange derivative products such as exchange traded futures and options as well as over the counter options, the matrix of regulatory regimes is probably increased by a *factor* of five.

That little example, Mr. Chairman, is reflective of the complex and technologically integrated financial world in which we live. And it is also reflective of why I come before you with the sense of urgency I hope I have conveyed. Much is at stake, not only for our financial institutions and markets but for our national well-being more generally. The longer we fail to forge a coherent approach to these problems, the greater the danger that we will find ourselves scrambling for ad hoc solutions in a less hospitable environment than we face today.