Balancing Progressive Change and Caution in Reforming the Financial System

Good morning, Mr. Chairman and members of the Committee. I am delighted to have this opportunity to appear before you to discuss again certain aspects of the ongoing efforts to reform and modernize the banking and financial system of the United States. In discussing these issues with you, I have, in words that Yogi Berra is alleged to have uttered, a sense of "déjà vu all over again." What I mean by that, of course, is that we have been discussing these issues for years. But now the time has come to act—a sentiment that I know is widely shared among the members of this Committee.

You have asked me, Mr. Chairman, to respond to a number of questions on the banking and commerce issue. While those questions are covered in the opening section of this statement, I have also included a number of observations on other aspects of the reform process as a whole, many of which bear on issues I have discussed with this Committee on earlier occasions.

In considering the specific question of banking and commerce as well as the larger question of reform of the banking system, it seems clear to me that the Congress is faced with a very difficult dilemma. On the one hand, the need for progressive reform is urgent, to put it mildly. On the other, the need for caution is equally strong, since so very much is at stake not only for the well-being of our financial system over time but also for the health and vitality of the economy at large. Striking the proper balance between progressive change and caution is not easy, but that goal is within reach. I might note at the outset that in my judgment permitting commercial firms to control banks fails on both counts. It is neither progressive nor cautious.

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, May 15, 1991

Banking and commerce

As the Committee knows, several weeks ago I appeared before the House Subcommittee on Telecommunications and Finance to discuss the banking-commerce question. At that time I submitted a rather lengthy statement. While I am sensitive to the appearance of placing before this Committee what may be viewed as a rerun, I have attached to this statement that earlier testimony. Even without the benefit of that lengthy statement, it will, I am sure, come as no surprise to you when I repeat my strong opposition to arrangements that would permit commercial firms to control banking institutions.

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While that opposition is steadfast in current circumstances, I also have said on many occasions—including before this Committee—that I am not opposed to providing a measure of greater flexibility in this area so long as the protections against control are not violated or threatened. In addition, I believe the basic ground rules associated with passive investments in banking institutions are badly in need of clarification. In part,

this need for clarification arises because the proliferation of new capital market instruments has made it very difficult to administer the existing rules in a setting in which there is a large grey area between investments of less than 5 percent, where control is presumed not to exist, and investments of 25 percent or more, where control is presumed to exist. Of course, if such clarifications are made regarding passive investments in banking organizations, logic would suggest that the same ground rules should govern passive investments by bank holding companies in firms whose scope of activities falls outside the "closely related" test in the Bank Holding Company Act.

I believe the basic ground rules associated with passive investments in banking institutions are badly in need of clarification.... The proliferation of new capital market instruments has made it very difficult to administer the existing rules in a setting in which there is a large grey area between investments of less than 5 percent, where control is presumed not to exist, and investments of 25 percent or more, where control is presumed to exist.

With that suggestion in mind, let me now turn to the specific questions posed by the Committee regarding controlling investments in banking institutions by commercial firms.

1. Would allowing commercial firms to acquire and control banks bolster the capital base of the banking industry?

The answer to this question is unclear. Whether or not the capital base of the banking industry would be increased depends on a number of factors, including the nature of the investments, their size, how they are financed and, very important, whether the "added" capital results from double-leveraging the existing capital base of the commercial firms making the investments. To the extent the latter is the case, the "increase" in the capital base in banking could, over time, prove to be illusory.

In important respects, however, the question whether the capital base in banking would be increased is the wrong question. Capital is attracted by profits. If the returns are not there, capital will not and should not flow to a firm or an industry. On the other hand, if the returns are there, capital will flow quite naturally. That is why it is so important to enact legislation that would remove the artificial barriers impeding the profitability of banking. In that environment, I am quite sure that sufficient capital will flow to the banking industry from traditional sources.

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Finally, it is by no means clear to me that the banking *system* does not have, or have access to, adequate capital from traditional sources. Indeed, given the obvious "overbanking" problem in this country, a good case can be made that part of the problem in banking and finance may well be that we have too much capital chasing too few *good* loans.

2. What impact, if any, would allowing commercial firms to control banks have on our nation's monetary policy?

If commercial ownership of banking organizations becomes widespread, there is a danger that the resulting concentration of economic—and perhaps even political—power could have subtle but serious implications for monetary policy. This would be true even though it is highly unlikely that such arrangements could, by themselves, undermine the technical linkages between monetary policy and the economy. That is, as a purely technical matter, there is some set of credit market conditions and interest rates that could be achieved by the monetary authorities that would, for example, check inflationary pressures in the economy. However, in an environment in which there is widespread control of banks by commercial firms, achieving that result could be more costly to the society at large. That possibility arises for two reasons.

Given the obvious "overbanking" problem in this country, a good case can be made that part of the problem in banking and finance may well be that we have too much capital chasing too few *good* loans.

First, if commercial firms controlled banks on a wide scale, the resulting economic power base might undermine the nation's will to resist short-run

temptations to live with a "little more" inflation. Since a central bank can only be independent *within* the government and the society it serves, these pressures could—in very subtle but insidious ways—undermine the capacity of the central bank to perform its necessary task of promoting long-

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term goals relating to price stability, financial stability, and overall economic stability

Second, if commercial ownership of banks resulted in a further increase in overall leverage—and especially double leverage—the fragility of both the financial and the nonfinancial sectors could increase further In turn, that result could either (1) produce a situation in which the monetary authorities might, in the short run, feel compelled to be more tolerant of financial excesses or (2) produce a situation in which both the financial system and the economy at large are more prone to disruptions and instability. In fact, the first of these dangers would surely give rise to the second. In that

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eventuality, the ultimate costs of checking these excesses—costs which could not be avoided forever—could be very great indeed

3. Would allowing commercial firms to control banks necessarily create new risks for the Bank Insurance Fund administered by the FDIC and for taxpayers who stand behind that Fund?

There is no question that such risks would increase, just as there is no question that the risks of the extension of the safety net more generally to the commercial owners of banks would increase. Reasonable men and women can debate the extent to which such risks might increase, but there is no doubt in my mind as to the direction of change

One compelling reason that such risks would increase is that there is no system of firewalls that is failsafe. Indeed, as outlined in my House statement in greater detail, the so-called contagion effects associated with problems in one part of a family of institutions simply cannot be safely isolated from the family as a whole. Experience has shown this to be the case time after time. When we need them the most, firewalls simply will not work

There is no system of firewalls that is failsafe. Indeed,... the so-called contagion effects associated with problems in one part of a family of institutions simply cannot be safely isolated from the family as a whole.

4 Do you think there is any validity to concerns, expressed by some, that allowing banking and commercial firms to combine would lead to an unhealthy concentration of economic power in this country?

Yes, these concerns are entirely valid In this connection, it is important to keep in mind that the nature of those risks is such that there is no middle ground on the banking-commerce issue That is, there are some who would ask why commercial firms should not be allowed to own selected banks. Or, why not allow commercial firms to own only troubled or failing banks? Implicit in these questions is the suggestion that we can have it both ways. That is, we can satisfy the desires of a few companies or a few banks, we can paper over some problems, and we can duck hard choices, while at the same time avoiding the concentration or other problems associated with commercial control of banks I just do not see it that way This is a very slippery slope and if we as a nation start down that slope we will, at that very instant, set in motion forces that will be very difficult and very costly to reverse.

5 Would allowing banking and commercial firms to combine necessarily undermine the arm's length relationship that now exists between banks and their creditors and weaken the cornerstone of effective banking, that is, independent credit decisions based on effective evaluations of creditworthiness?

"Necessarily" is a very strong word, but if the question were restated in terms of the *risks* to the impartiality of the credit decision-making process, the answer is clear. Yes, those risks would

increase. The extent of the increase would, of course, depend upon how far and how fast a pattern of commercial ownership of banks might take hold. But even if the risks are perceived as relatively small, the costs could be very high

6. Would a commercial firm that owns a bank be more apt to make its bank's credits available to its customers rather than to customers of its competitors?

Again, those risks would be present In fact, these risks exist in virtually every facet of banking even without commercial ownership With commercial ownership of banks, those risks would rise appreciably On the other hand, as long as banking markets are truly competitive and as long as appropriate supervisory policies are in place, these risks are manageable. However, keeping them manageable in a context of commercial ownership of banks would be another story, especially given all the other problems that would arise in those circumstances.

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To summarize, the risks associated with commercial ownership and control of banks are considerable In my view, we as a nation should be prepared to run those risks only if there is some compelling public policy reason that dictates that course of action I see nothing on the horizon that would qualify as that compelling public policy case for permitting such combinations. Thus, unless something changes radically, I remain steadfast in my opposition to commercial ownership or control of banking institutions

Progressive but cautious reform

While combining banking and commerce does not meet the test of either progressive or cautious change, there are proposals before this Committee and the Congress that in my judgment would pass both of these tests. There are also pressing needs—such as the recapitalization of the bank insurance fund—that must be attended to promptly As I see it, however, it would be a grave mistake were the Congress only to enact legislation to deal with the financial needs of the Bank Insurance Fund, even if such legislation also included an appropriate title on "progressive supervision" and "early intervention" The Congress must recognize that the realities of the marketplace, including changing technology, are such that the current configuration of the banking and financial system in the United States is entirely too accident prone—a condition that ultimately threatens the capacity of the system to perform its vital economic tasks. Moreover, it is badly out of line with emerging trends throughout the world—to the continuing detriment of the international competitiveness of U S. institutions and markets.

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Whether we like it or not, we are going to see an important degree of consolidation in the U S banking and financial system That result, as I am prone to say, is already baked in the cake. The question, therefore, is not whether that process of consolidation will occur, but rather whether it will occur the hard way or the easy way and whether it will occur in a manner that is consistent with the public interest Narrow legislation, in my view, virtually assures that we will be back in this room two or three or five years from now pasting together another damage control package in circumstances in which the task will be all the more difficult and the public interest all the more at risk

When I speak of the inevitability of an important degree of consolidation in banking and finance, I do not mean to imply that we in the United States will end up with a highly concentrated banking and financial system such as we see in many other countries I simply do not see that occurring here Indeed, I would be vigorously opposed to such an outcome. Even putting aside regulatory restraints and antitrust laws, the realities of banking markets and relationships in this country are such that we will continue to have thousands—but not as many thousands—of banking and financial institutions. Moreover, I am absolutely certain that legions of inde-

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pendent community banks will survive and thrive in this otherwise changing environment.

Against this background it seems clear to me that striking the right balance between the dictates of progressive and cautious change requires—indeed demands—more than patchwork legislation. Yes, the Bank Insurance Fund must be recapitalized, and yes, there may be still unexplored ways to produce that result in a manner that minimizes adverse implications for the competitiveness of U.S. banks. Yes, a flexible system of "progressive supervision" and "early intervention," with the qualifications suggested by Chairman Greenspan in his April 23 testimony, should be enacted. Yes, a *very* careful and deliberate approach to deposit insurance reform can help.

But these changes, as necessary and as important as they are, are not sufficient because they do not get to the heart of the structural, competitive, and technological factors that are driving so many of the changes and problems we see in the banking and financial system. That is why any legislation that would meet my personal standard of progressive change would also have to get at these basic structural problems and thus include—*at a minimum*—the effective repeal of McFadden, Douglas, and Glass-Steagall.

Any legislation that would meet my personal standard of progressive change would also have to get at these basic structural problems and thus include—*at a minimum*—the effective repeal of McFadden, Douglas, and Glass-Steagall.

I recognize that some would suggest that, in the name of progressive change, I am throwing caution to the wind in taking that position. I also recognize that against the history of the savings and loan mess, even a hint of throwing caution to the wind takes on special significance to the Congress and the American taxpayer. Allow me, therefore, to make several points that I believe will suggest that these structural changes can be made in a manner consistent with the need for caution.

First, the risks—and there are risks—of making these structural changes must be weighed against the risks of not making the changes. As noted earlier, the most important of the risks associated with not making the changes is that it would frustrate the necessary process of consolidation, cost reduction, and diversification in the banking and financial system and further undermine the competitiveness of U.S. banking institutions at home and abroad. Put differently, absent these progressive structural changes, the risks of further stress and instability in banking and finance will increase.

Second, whatever else may be said of these changes, they will, over time, work in the direction of permitting institutions to better diversify their risks and their sources of income. This is important because when we look for common denominators among institutions that have failed, one (other than poor judgment and management) that stands out time and again is concentration of activities and credit exposures. In this regard, it should be stressed that, over time, the benefits of diversification of risk and income flows that would follow from these structural changes would not accrue solely to banking institutions. To the contrary, I would think that important benefits would also arise for securities firms by virtue of their ability to own banks. I assume that this is one of the reasons that so many securities firms own nonbank banks in the United States and own banks in foreign countries.

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Third, under the system of progressive supervision I have in mind, the benefits of the repeal of these outdated laws would accrue only to the strongest of institutions, taking into account not simply capital positions but also the full range of supervisory criteria. In this connection it should be noted that over the course of the recent credit crunch, call report data point to a striking difference between the rate of commercial and industrial loan origination by strong banks and that of weak banks in all parts of the country. In other words, while commercial and industrial lending has, of course, slowed across the board, that pattern is more evident at weak banks than at strong banks. This finding in itself is suggestive of why it is so important to promote strength and diversification in banking institutions.

Fourth, as a part of the process, there are several areas in which overall supervisory standards and practices must be strengthened. The system of progressive supervision based on capital zones that is part of the Treasury proposal and is incorporated into several other legislative proposals is responsive to this need for strengthening the supervisory process. However, capital and other prudential standards are, in my judgment, only as good as the on-site examination and inspection process. That is why I believe it is so very important that major emphasis be placed on strengthening the

examination process. In saying that, I recognize that there are several proposals before the Congress calling for annual examinations of all banks or banking institutions

It is important that Congress recognize that achieving this goal—while important—is going to be expensive—very expensive. I say that with the knowledge that many banks are not now subject to annual examinations *and* with the knowledge that even when examinations occur annually, important differences can arise in the scope of the examinations in such crucial areas as the composition and size of the sample of loans reviewed by the examiners While it will be expensive, Congress should also recognize that these costs will be very small relative to the costs of not taking the necessary steps to reinforce the examination process.

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At the Federal Reserve Bank of New York we have maintained the practice of "full scope" annual examinations for virtually all institutions under our supervisory jurisdiction and certainly have maintained that practice for *all* major institutions under our jurisdiction At times, the annual exam is supplemented by limited-scope or targeted examinations within a twelve-month period

There is another important consideration in this regard. Namely, the examinations can only be as good as the examiners. I am proud of my examination force, and I know that they are good—damn good—at their profession I believe these examiners are among the best in the business—a view that I suspect is shared by their peers here and abroad. But let's be realistic. The Federal Reserve Bank of New York employs 206 bank examiners whose average tenure is eight years and whose average salary is about $50,000 But these 200 individuals—together with their in-house analytical and support staff—are directly responsible for inspections of 7 of the 15 largest bank holding companies in the country with aggregate assets of over $650 billion, federal examinations of 5 of the 10 largest banks in the United States, and federal examinations or inspections of about 175 other banks or bank holding companies, as well as standby or backup examination authority for about 250 foreign banking institutions operating in New York. Their work covers not only financial examinations but also a wide range of so-called compliance examinations in such areas as community reinvestment activities of banks

What I am suggesting, of course, is that the demands on the bank examination process, regionally and nationally—a process that I regard as the bedrock of the overall supervisory process—are enormous As an extension of that, the Congress must recognize that to get it right will entail added resources of not inconsequential dimensions. This will be especially true in a setting in which interstate banking will bring with it the need to redouble our efforts in such areas as compliance examinations regarding the Community Reinvestment Act. I might also add that the suggestion that restructuring of the bank examinations agencies would produce large offsetting savings is wrong The amount of cooperation between the agencies at the federal level is considerable, and the amount of duplication is limited.

The demands on the bank examination process, regionally and nationally—a process that I regard as the bedrock of the overall supervisory process—are enormous. As an extension of that, the Congress must recognize that to get it right will entail added resources of not inconsequential dimensions.

Fifth, this is not the time to relax supervisory standards as they apply to consolidated groups housing banking entities or to their parent holding companies. Not only would such a move be wholly incompatible with practices throughout the industrial world—practices that were recently confirmed in an emphatic fashion by the Swiss courts—but it would also ignore the fact that these holding companies are the financial and managerial nerve centers of the groups of entities they control The holding company is also the major—and usually the sole—point of entry to the capital markets for the consolidated entity and all its component parts.

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In those circumstances and in the face of the difficult current and prospective problems, the relaxation of prudential standards at the level of the holding company strikes me as a major mistake Accordingly, consistent with the position I have taken before this Committee on earlier occasions, I strongly favor supervisory policies

at the level of the holding company that—at the least—would include (1) minimal capital standards on a fully consolidated basis, (2) a program of on-site inspections of such companies along the lines of current practices, (3) consolidated reporting requirements, and (4) standby authority for inspection or examination of any unregulated affiliate of a holding company controlling depository institutions

I have carefully considered the arguments for a lesser degree of ongoing supervision of holding companies Some of these arguments have some merit, even if I personally do not find them persuasive But even if the arguments were fully persuasive as presented, they leave one glaring problem namely, the suggestion that supervision can or will be strengthened when problems become apparent The reality, of course, is that experience strongly suggests that when the problems become apparent, it is already too late

Sixth and finally, it is possible to stage or phase in certain of these structural changes in such a way as to provide the Congress and the public with the necessary comfort that the process is occurring in an orderly fashion and in a manner ensuring that necessary changes in supervisory policies and practices are in place. There are any number of devices that could be used for this purpose. Further, at the risk of sounding bureaucratic, consideration might be given to the *temporary* establishment of a body styled on the Depository Institutions Deregulation Committee of the early eighties to coordinate and oversee this transition, including the preparation of periodic reports to the Congress on the progress of and problems with the effort

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There is no course of action open to the Congress in the banking reform process that is risk free There are risks with no legislation; there are risks with narrow legislation, and there are risks with broad legislation However, I am convinced that with appropriate safeguards and careful implementation, the risks associated with prudent broad legislation are lower and more manageable than the risks associated with the alternatives Moreover, only broad legislation gets to the fundamentals that are at the root of so many of the current problems in the banking and financial system

Deposit insurance, "too big to fail," and systemic risk

While caution is needed in all aspects of this effort, nowhere is the need for caution greater than in efforts to cope with the highly sensitive and interrelated problems of deposit insurance reform, "too big to fail," and systemic risk

The economic and political sensitivities surrounding the so-called too big to fail issue are understandably great. In part that is true because of the obvious equity issues that arise in this connection But the problems go well beyond the equity issues. For example, to the extent that practices produce a situation in which the financial landscape is littered with inefficient institutions—small or large—and to the extent that strong institutions must pay for the mistakes or abuses of weak or reckless institutions, the economic costs of such practices can be considerable

Having said that, I should also say that the semantics of "too big to fail" are often misleading On the one hand, shareholders, managers, and, increasingly, bondholders are not protected from "failure" On the other hand, we have seen any number of cases here and abroad in which decisions by governmental authorities—including state governments—have been made to protect broad classes of investors or depositors when the banking institution that was at risk of failure was not at all large and in fact was quite small. What that says, of course, is that while the phrase "too big to fail" is catchy, the reality it seeks to describe is much more complex than the words suggest. The reality is that there are circumstances in which public authorities can and should reach the conclusion that the threat of losses on deposits—or perhaps even other categories of loss—carries with it risks to the well-being of the financial system as a whole that can easily justify taking extraordinary measures to protect against such losses. In other words, the authorities cannot afford to ignore the systemic risk phenomenon

The reality is that there are circumstances in which public authorities can and should reach the conclusion that the threat of losses on deposits—or perhaps even other categories of loss—carries with it risks to the well-being of the financial system as a whole that can easily justify taking extraordinary measures to protect against such losses.

Systemic risk is one of those things that is hard to define but easy to recognize Indeed, speaking as someone who has been at least indirectly involved with

efforts to contain virtually every major financial disruption in this country for more than a decade, I can assure you that the threat of systemic risk can be very real I can also say that while we have had a few close calls, we have not had a situation in which serious problems in one institution, a class of institutions, or a segment of

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the financial markets have spread to other institutions and markets in such a way as to inflict serious and very costly damage on financial markets generally or on the economy Those latter conditions are, of course, what moves systemic risk from threat to reality

With that in mind, a natural question is: What is it about financial institutions and financial markets that creates the systemic risk problem in the first instance? The short answer can be given in two words confidence and linkages. The confidence part of that answer is well understood. But it should be stressed that the confidence factor relates not only to public confidence in financial institutions but also to public confidence in the authorities' understanding of these institutions and markets and to public confidence that the authorities will act in a responsible fashion when confronted with problems

The linkage aspect of the systemic risk problem,... while related to the confidence problem, grows out of the enormously complex network of counterparty credit, liquidity, settlement, and operational risks and contingent risks on a national and international scale that characterizes contemporary financial markets and institutions.

The linkage aspect of the systemic risk problem, unfortunately, is not always well understood. The linkage problem, while related to the confidence problem, grows out of the enormously complex network of counterparty credit, liquidity, settlement, and operational risks and contingent risks on a national and international scale that characterizes contemporary financial markets and institutions The scale and complexity of these contractual obligations and counterparty risks are very difficult to convey Let me try by way of example On a typical business day, the Federal Reserve Bank of New York processes or settles about $2 trillion in electronic transfers or payments While I can only guess, it would not surprise me if the total daily payment flows through the New York money markets were at least double that amount To put that in perspective, a heavy day on the New York Stock Exchange entails transactions with a value of only $8 billion or $9 billion At the other extreme, the GNP for the United States for the year 1990 was $5.5 trillion Virtually all banking institutions—small and large, local, regional, and national—have direct or indirect credit or counterparty exposures that grow out of these transactions flows

The reason that these linkages are so important to the systemic risk issue is that in the face of a problem or a perceived problem at a particular institution or group of institutions, other institutions will, quite naturally, take steps to protect themselves from outright loss and from the threat that money, securities, or other financial assets will not be delivered to them or that existing contracts will not be honored This, in turn, gives rise to the threat of financial "gridlock," a threat that can easily take on the classic characteristics of a self-fulfilling prophecy. If, in those circumstances, confidence in the workings of the system begins to erode,

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the systemic problem is at hand In this context, it is very important to recognize that when all is said and done, the payment flows that permit the system to work can be made only through transactions accounts at banks.

This, of course, is why the payments system is so very important to the stability and integrity of the financial and economic system It is also why the Federal Reserve, like most central banks, plays a direct role in the operation and the oversight of the payments system It is also the reason that payments, clearance, and settlement systems can so easily be the mechanism through which a localized problem in the financial system can take on systemic elements Finally, it is the reason that in recent years the Federal Reserve has put so very much effort into improvements in the safety, integrity, and reliability of payment, clearance, and settlement systems and, in the process, has assumed a position of leadership in parallel efforts throughout the world.

Because these issues of confidence and linkages are

so central to the systemic risk problem and because they are so subtle, so complex, and at times so threatening, some may question the wisdom of specific decisions made from time to time by the authorities in the face of particular problems in the financial system. That is understandable, but I am quite sure that there would be a great deal more questioning if a miscalculation resulted in a seemingly isolated event triggering a widespread and very costly systemic problem.

Looked at in that light, the problem is not that any institution is too big to fail. The problem is that there are institutions and there are circumstances—*and not just circumstances involving banks or big banks*—when the sudden and uncontrolled demise of one or a group of institutions, large or small, could unleash a series of events that take on systemic implications. In some cases, that reality requires that the authorities step in and play a major role in doing all that can reasonably be done to ensure that the demise of such an institution takes place in an orderly fashion. This was the case with Drexel. In other cases, it might require, for example, that all depositors in a bank be kept whole even in the face of insolvency and the $100,000 formal limit on deposit insurance.

Systemic risk—especially in its very complex contemporary form—is a reality. It cannot be legislated away; it cannot be regulated away.

What I am suggesting, of course, is that systemic risk—especially in its very complex contemporary form—is a reality. It cannot be legislated away; it cannot be regulated away; and as suggested by experience all over the world, neither it nor the behavior of the authorities in the face of stress in the system arises out of the mere presence of a formal system of deposit insurance, no matter how poorly or how well that system is designed or administered.

To put it differently, any satisfactory solution to the "too big to fail" problem and the related issue of deposit insurance reform must start with efforts that will reduce the risk of failures in the system at large and efforts that will provide the authorities with the tools and the ability to better contain and manage problems when they arise. This, again, is why broad legislation is so necessary; the structural changes get at the first of these needs, while the supervisory and regulatory changes—including early intervention—get at the second.

I might add in this regard that early intervention may also help overcome one of the major practical obstacles to greater reliance on "open bank" solutions to problem institutions. That is, under current practices, it is difficult to organize competitive bidding packages for seriously weakened but still solvent and open banks. With clear legislation permitting early intervention in such circumstances, the benefits of competitive bidding can be realized even though the bank is open and technically solvent.

This can be very important because experience clearly suggests that the losses in banks that no longer have "going concern" value tend to increase dramatically, thus raising the cost to the deposit insurance fund. More importantly, open bank solutions clearly can help to contain and reduce the systemic risk problem, and anything that works in that direction also works in the direction of reducing the inequity and other problems associated with "too big to fail."

In all these circumstances, there are clear limits on how much can safely and constructively be done in the area of deposit insurance reform at the present time. As the banking system regains its strength, that will change. However, there is one aspect of the deposit insurance issue that warrants further comment, and that relates to brokered deposits. There is no question that in the savings and loan mess the abuse of brokered deposits was a major contributor to the overall problem. Partly for this reason and partly because it is now so easy and so inexpensive to break large chunks of money into $100,000 pieces and deploy such monies into fully insured deposit accounts in multiple banking institutions, the brokered deposit phenomenon seems to collide head on with one of the basic purposes of deposit insurance. For that reason, and because practical alternatives are hard to come by, the Treasury proposal would essentially eliminate insurance coverage on brokered deposits over a two-year period.

Any satisfactory solution to the "too big to fail" problem and the related issue of deposit insurance reform must start with efforts that will reduce the risk of failures in the system at large and efforts that will provide the authorities with the tools and the ability to better contain and manage problems when they arise.

While that approach has some appeal, it has the obvious disadvantage that it would eliminate those aspects of the brokered deposit market that serve a constructive purpose. I can see only one way to protect against the abuses of brokered deposits while still maintaining a viable marketplace for brokered deposits. That approach would center on attacking the problem not at the source but at the use. It might be possible, for example, to further strengthen the provisions of the Finan-

cial Institutions Reform, Recovery, and Enforcement Act as they pertain to brokered deposits by some combination of (a) adding disclosure rules, (b) providing explicit cease and desist authority regarding the use of brokered deposits by *any* depository institution, and (c) establishing of licensing or registration requirements for all money brokers.

I can see only one way to protect against the abuses of brokered deposits while still maintaining a viable marketplace for brokered deposits. That approach would center on attacking the problem not at the source but at the use.

If something along these broad lines cannot be made to work, I must confess I would then side with the Treasury, even though I recognize that this approach has the obvious disadvantage of throwing away the good with the bad.

To summarize, given the current condition of the banking system and the difficult transition that lies ahead even under the best of circumstances, there are no easy answers to the closely interrelated issues of deposit insurance reform, "too big to fail," and systemic risk. To the extent that the Congress can enact broad and progressive legislation along the lines described earlier, such legislation would attack these problems from two directions: First, the combination of progressive supervision, prompt resolution, Fed-Treasury discretion in the face of systemic problems, limited changes in deposit insurance, and a strengthened system of supervision and examination would tend to contain and minimize these problems over the next several years of transition. Second, structural changes in such areas as McFadden, Douglas, and Glass-Steagall—with the safeguards suggested—would work in the direction of facilitating an orderly process of consolidation while providing greater opportunities for profitability and diversification, thereby getting at the heart of the structural and competitive problems in banking and finance.

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As this transition occurs, the Congress and others should give further consideration to what additional steps might be taken to strike a better balance between the workings of the marketplace and reliance on the safety net. In that setting, consideration could be given to other possible reforms in deposit insurance, perhaps along the lines suggested by Senator Dixon and others. Who knows for sure? Maybe we will get lucky, and the progressive legislation of 1991 might yield an outcome by 1994 or 1995 that does not require further major surgery.

Supervisory policy and the role of the Fed

On a number of earlier occasions I have stated to this Committee my belief that the Federal Reserve, as the nation's central bank, must maintain an important role in the bank supervisory process. In saying that, I have acknowledged that such a statement, coming from me, cannot help but be construed by some as a position that is motivated by institutional self-interest. I recognize that danger, but because I believe the principle is so important, allow me to conclude with a further elaboration on this point.

As with any chief executive officer, one of my most important duties is to try to motivate the employees who work for me and to try to make sure they understand why their individual jobs are important and how their individual duties fit into the bigger picture. In doing this, I often refer to what I like to call the "trilogy" of responsibilities of the central bank. The concept of the trilogy is borrowed from the literary world where its definition centers on three works that are closely related and develop a single theme. In the context of the Federal Reserve, the three components of the trilogy are: monetary policy, which, of course, stands at the center of the trilogy; the broad oversight of financial markets and institutions, with special emphasis on banking institutions; and the oversight of and direct participation in the workings of the payments system. If those are the elements of the trilogy, the single theme that unites them is stability: price stability, financial stability, and overall economic stability.

The components that make up that trilogy of functions are not separate and distinct; each depends on the others in precisely the same manner that the components of the literary trilogy depend upon one another. If any one is left aside, the essence and common theme of the trilogy are lost.

While the analogy of the trilogy may be new, the recognition of the interrelationship of these specific functions is not. Indeed, that recognition was at the very center of the thinking that went into the creation of the Federal Reserve in 1913. In fact, the preamble to the

Federal Reserve Act specifically mentions the role of the Fed in the supervisory process. It reads: "to provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

Against that background, I must confess that I find it a little difficult to comprehend the view that essentially says, "let the Fed tend to its monetary policy knitting and leave bank supervision to others." I find that view especially difficult to comprehend in the context of supervisory responsibilities as they apply to major banking organizations, where the systemic risk problem can be so very real.

As I see it, the view that monetary policy is separate and distinct from supervisory policy and that either or both can be separated from the workings of the payments system and from the systemic risk problem can be based only on a dangerously narrow view of what monetary policy is all about.

As I see it, the view that monetary policy is separate and distinct from supervisory policy and that either or both can be separated from the workings of the payments system and from the systemic risk problem can be based only on a dangerously narrow view of what monetary policy is all about. Indeed, if there was nothing more to monetary policy than a mechanical decision whether the central bank buys or sells on a given day, one could argue that monetary policy and bank supervision are separate and distinct functions. But in the United States and throughout most of the industrial world, this sharp distinction is not accepted. Indeed, the drafters of the proposed statute for the European System of Central Banks and the European Central Bank have included among the five basic tasks of the European Central Bank the following: "to participate as necessary in the formulation, co-ordination and execution of policies relating to prudential supervision and the stability of the banking system."

In practice, monetary policy is not, and will never be, a simple mechanical decision to buy or sell. It entails judgment, and one very important component of that judgment relates to conditions in financial markets and financial institutions, including a detailed working knowledge of such markets and institutions. For example, monetary policy was appropriately influenced by such events as the recent "credit crunch" and the 1987 stock market crash. In other cases, such as the Drexel episode or the "mini" market crash of 1989, monetary policy was not so influenced. In all such cases, however, the decision whether such events should influence monetary policy—even if only for a matter of days—must be faced and made one way or the other. Obviously, such decisions must be made in an informed manner. A very crucial ingredient in that decision making comes from the direct, hands-on knowledge of the Federal Reserve that grows out of its supervisory responsibilities and its resulting close interaction with banking institutions—institutions that remain the "cushion" or the "shock absorber" of the financial system as a whole. Moreover, I can assure this Committee that the necessary insights to make those decisions cannot be gained simply by reading some other agency's examination or inspection reports.

In practice, monetary policy is not, and will never be, a simple mechanical decision to buy or sell. It entails judgment, and one very important component of that judgment relates to conditions in financial markets and financial institutions, including a detailed working knowledge of such markets and institutions.

This is not to say that there may not be, from time to time, conflicts between monetary policy and supervisory policy. To the contrary, such conflicts do arise. The point is that in resolving those conflicts, the central bank must be part of the solution and not part of the problem.

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The direct linkages between banking supervision and the conduct of monetary policy are important, but they do not tell the whole story why it is crucial that the Fed continue to play a major role in the supervisory process. What is even more important is that the stability of the financial system is a prerequisite not only to the conduct of monetary policy but also to the very goals of price stability and economic stability. They are a package deal; you cannot have one without the others. That is why every central bank that I know of is the "lender of

last resort"; that is why the integrity and safety of the payments mechanism is so important; that is why the central bank must concern itself with the safety and soundness of those institutions that constitute the nerve center of the financial system at the local, regional, and national levels.

In these circumstances, I would hope that any restructuring of the responsibilities of the federal bank regulatory agencies would preserve a lead role for the Federal Reserve. Having said that, I will quickly add that I see no reason to undertake that regulatory restructuring task now. For one thing, the status quo, while not perfect, does work reasonably well. Beyond that, logic suggests the wisdom of getting the structural reforms of the banking and financial system firmly in place and then forging the regulatory apparatus to meet the needs of the changed system as it takes hold in practice. Finally and perhaps most importantly, it seems to me quite risky to try and put in place massive regulatory restructuring as we work our way through the very difficult transition that lies ahead. That would only elevate the risk that something of consequence will fall between the cracks.

It is crucial that the Fed continue to play a major role in the supervisory process.... The stability of the financial system is a prerequisite not only to the conduct of monetary policy but also to the very goals of price stability and economic stability.

Summary

My opposition to legislation that would permit commercial firms to control banking institutions is well known to this Committee. I have tried in this statement, and in its attachment, to spell out in detail the reasons for that position. But as strong as my opposition to banking-commerce combinations is, my support for what I have described as progressive but cautious legislation is even stronger. Few items on the national agenda strike me as having greater long-run implications for the health and competitiveness of our banking and financial system—and therefore our economy—than does the enactment of such broad-based progressive legislation this year.

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