A Framework for Reform of the Financial System

Mr. Chairman, members of the Committee, I am pleased to have this opportunity to appear before you today to discuss broad-based reform of our banking and financial system. In my judgment, few issues before the Committee or before the Congress generally are more pressing or more important than is the subject of these hearings. Many of the issues and questions raised in your letter of invitation have been covered in my recent essay, *Financial Market Structure: A Longer View*, and in a major study on bank profitability completed by the Federal Reserve Bank of New York last year. Accordingly, I would ask that both of these documents be submitted for the record. I should also say at the outset that I am appearing here today in a personal capacity and not on behalf of the Federal Reserve System.

I approach the subject matter of these hearings with a deep conviction that participants in the process must rise above parochial interests. Indeed, to the extent that firms, groups of firms and their lobbyists continue to approach the process of banking and financial reform with the "winner-take-all" mentality that has been all too evident in the past, there will be no winners. What is fundamentally at issue here is not a turf war but rather how we as a nation can best see to it that legitimate public interest considerations associated with a safe, efficient and impartial banking and financial system are well served. I, for one, believe that goal is within reach, but I also believe that time and events are not in our favor Indeed, the longer we wait, the more difficult the task becomes, and the greater the risks that an unpleasant surprise will intervene. As we all know, in such circumstances efforts aimed at reform can quickly take on a regressive, rather than a progressive, character.

Statement by E Gerald Corrigan, President, Federal Reserve Bank of New York, before the United States Senate Committee on Banking, Housing, and Urban Affairs, on Thursday, June 18, 1987

The case for reform

As I see it, the case for fundamental reform in our banking and financial system is compelling The speed and scope of change we are seeing in our financial markets and institutions have taken on a revolutionary character. But, revolutions do not occur in a vacuum—they have their causes. In this particular case, many of the causes are to be found in patterns of economic performance here and around the world over the past decade or more Over the same time frame, changing technology and innovation have fostered the application of very sophisticated forms of mathematics and computer technology to the financial marketplace, making possible the design of new techniques, new instruments, and worldwide trading and funding strategies. These developments have worked to highlight longstanding differences in supervisory, tax, accounting and regulatory treatment of classes of institutions here and abroad, thereby further sharpening competitive differences and incentives for patterns of behavior that exploit loopholes

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and circumvent supervisory policies. Thus, while it is beyond debate that the process of change and innovation has brought with it important benefits, there persists a nagging sense of unease—a sense of unease that is prevalent among financial market practitioners themselves—that all is not well. To some considerable extent, that sense of unease seems to grow out of the concern that legitimate broad-based public interest considerations about the structure and stability of financial markets and institutions are being swept aside in a helter-skelter of events that lacks an underlying sense of direction and may be weakening the system.

In considering this crosscurrent of events and circumstances that is at work in the financial marketplace, there is one further point that should be raised. Namely, there is also the subtle danger that the developments we are witnessing—at least at the margin—are being reinforced by a belief that the public safety net associated with banking and finance will protect not just the system as a whole but also all of its individual component parts, including those who have acted in an irresponsible and undisciplined manner. To the extent that perception exists it must be changed, for of all the freedoms contemplated by the current environment, the freedom to fail must be part of the equation. To put it differently, we simply cannot have a financial system in which even a few participants seem to believe that standards of behavior start with the maximization of profits and end with the socialization of losses.

Banking, finance and the public interest

For decades, indeed for centuries, it has been recognized that there are characteristics associated with banking and finance that warrant a higher level of official supervision than is associated with most other forms of commercial enterprise. In this regard it should be of more than casual interest to note that one of the earliest and strongest voices for the regulation of banking was none other than Adam Smith, writing in the *Wealth of Nations*. Even in this age of deregulation, the central question before us is not whether the banking and financial system should be subject to official supervisory oversight but rather how we strike an appropriate and reasonable balance between the dictates of competition and efficiency on the one hand and safety and integrity on the other.

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Seeking to achieve that necessary balance in current circumstances runs afoul of many practical difficulties but it also is hampered by an intellectual barrier. Namely, in looking at the particular functions of the banking and financial system that are of special importance in a public policy perspective, there is something of a natural tendency to take their significance for granted and to look at them in isolation

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That is, there is a tendency to say there is nothing unique or special about extending credit; nothing unique or special about making or receiving payments, or nothing unique or special about issuing transaction or demand balances. The difficulty, of course, is that these functions cannot be looked at in isolation but rather, must be viewed as something of a trilogy—the unifying force for which is that the system as a whole is a credit system in which very large amounts of claims on financial institutions must be satisfied on demand or on very short notice Those claims include not just the stock of conventional "demand" deposits housed in depository institutions but also the hundreds of billions of dollars in debit and credit entries made daily that are now associated with our highly integrated financial markets on a worldwide basis Therefore, each institution in the loop must not only satisfy itself that it is making all of its credit judgments in a rigorous and objective manner, but it must also have confidence that others to whom it may be indirectly exposed are doing the same For these reasons, and because the business of banking and finance is essentially the business of public and mutual confidence, the public at large and market participants more specifically have expected and demanded a degree of official surveillance over the system—a system in which credit and credibility are the unifying forces.

The process of reform: overall objectives

While the details of efforts aimed at financial reform are very complex, it seems to me that the objectives of reform are quite straightforward and reduce to only three key elements

- First, we want a market-driven system in which our

scarce financial resources are mobilized and allocated in the most efficient and cost-effective manner.

- Second, we want a system in which the impartiality of all elements of the credit decision-making process is preserved if not enhanced.
- Third, we want a *system* which is strong enough to withstand shocks, disruptions and failures in its component parts, even if the component part in question is large. This latter consideration is of particular importance in a setting in which some observers believe that the system is more fragile or more accident-prone than it should be or than it need be. As an extension of this, we also want a banking and financial system that is strong enough to serve as the transmission vehicle through which monetary policy influences overall economic activity.

In considering how to translate those broad objectives into a series of operational principles, I believe we must keep several related points in mind. These include:

- First, the capital resources needed to safely support banking and financial enterprises will only be forthcoming to the extent the returns on that capital are high enough to attract capital resources from alternative and competing uses
- Second, given the realities of global financial markets, the structure we choose to adopt here must at least be sensitive to arrangements elsewhere. In that regard it should be stressed that with changes now taking place in the United Kingdom and Canada, the United States and Japan are the only remaining major countries that do not permit rather generalized blending of banking and other financial enterprises within the same corporate entity.
- Third, contrary to segments of opinion, concerns about the stability of the system are not limited to problems at large institutions. To be sure, problems at large institutions are often more difficult to deal with and will generally entail systemic considerations But, let me remind the Committee that in 1985 we experienced a chain of events that were threatening indeed, even though "major" institutions were not a direct part of the problem.

That chain of events began with the failure of a small Florida securities firm, which then (1) spread to Ohio where it unleashed the Ohio thrift crisis, (2) triggered the failure of a second small securities firm, which in turn (3) resulted in circumstances which came very close to putting the entire market for mortgage-backed securities into gridlock, and (4) produced the Maryland thrift crisis, including its spillover into certain real estate firms, which in turn threatened the well-being of several important mortgage insurance companies.

- Fourth, while we can draw comfort from the enhancements to the financial safety net that have been put in place over the past several decades, we should not allow that sense of comfort to delude us into thinking that arrangements that were conceived in the past are necessarily sufficient for the present, much less the future. In this regard I would want to emphasize that the speed, volume and complexity of contemporary financial markets are of a very different order of magnitude than they were even a decade ago, as is the nature of the worldwide operational, liquidity and credit interdependencies that grow out of these arrangements. When I see days in which the electronic payments flowing through the Federal Reserve Bank of New York exceed $1.5 trillion—something I see with some frequency—the realities of these worldwide interdependencies are very vivid indeed.

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The process of reform: guiding principles

In my own thinking about a practical approach to reform of the financial system, I have given important weight to six guiding principles that, as I see it, flow out of the broad objectives mentioned above. These guiding principles are as follows:

- First, the separation of "banking" from commerce should be preserved.
- Second, in the interest of competitive equity and supervisory harmony, the regulatory costs associated with special "banking" functions should, to the fullest extent possible, be neutralized or eliminated across classes of institutions.
- Third, the approach should provide scope for achieving the benefits of greater competition in the marketplace for financial services while preserving the important public benefits growing out of an appropriate degree of supervisory oversight of the system.
- Fourth, supervision should take account of function, not merely institutional form.
- Fifth, the structure of the system should incorporate principles of "volunteerism" whereby individual firms can choose their position on the financial landscape based on their own corporate strategies and their own assessments of the costs and benefits of one

form of corporate organization over others.

- Sixth, and most importantly, the approach should strengthen the stability and soundness of the system in part by providing greater room for self- and market-discipline but also by enhancing the strength and flexibility of the official supervisory apparatus where necessary.

Building on these principles, the structure I have suggested can be summarized as follows:

- First, the approach would maintain a basic separation between banking and commerce while permitting firms engaged in providing financial services to operate in a broad range of banking and financial product and service markets. That is, common corporate ownership of banks, thrifts, insurance companies, and securities companies would be permitted—subject to appropriate regulatory restraints—as would combinations of commercial firms and nonbank financial concerns. However, commercial firms could not own and control insured depositories. On the other hand, securities, insurance or other financial concerns could own and control insured depositories subject, of course, to appropriate supervisory policies. The approach is fully consistent with the view that "banks are special" while at the same time sensitive to the market realities associated with the provision of financial services in a contemporary setting here and abroad.

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- Second, the approach recognizes that competitive realities require that artificial distinctions between classes of financial institutions offering functionally similar financial services must be narrowed, especially as they pertain to those financial services that are of particular concern from a public policy perspective. Accordingly, the proposals would:
  - eliminate the prohibition against paying interest on transaction deposits;
  - provide for the payment of interest on required reserves;
  - make all transaction accounts subject to required reserves;
  - eliminate required reserves on nonpersonal time deposits,
  - establish an interest-earning liquidity reserve applicable to all major direct participants in the large-dollar electronic payments network;
  - broaden the class of institutions that have some form of direct access to the payments mechanism and the discount window; and
  - broaden the class of integrated financial institutions that are subject to a degree of consolidated official supervision by the Federal Reserve.
- Third, the approach would also usher in a greater degree of more balanced competition in the marketplace for banking and financial services. Indeed, by permitting combinations of financial and banking entities in a setting in which commercial firms may continue to offer a full range of nonbank financial services, the thrust of competitive forces would be driven more by market considerations. However, all of this would take place in a framework in which the supervisory apparatus associated with banking and finance would be preserved and enhanced. And, it would also be possible to phase in such arrangements over a period of time in a manner not unlike that in which regulation Q ceilings were reduced and then eliminated over a period of time under the provisions of the 1980 Monetary Control Act.
- Fourth, official supervision would increasingly take account of function, not merely form. This goal is achieved in several ways, including by virtue of the steps outlined in the second item above. Beyond those particular suggestions, the approach also contemplates:
  - the adoption of risk-based capital standards for U.S. banking organizations that would permit a convergence in such standards between U.S. banks and foreign banks and over time would also be conceptually compatible with the goal of achieving a greater degree of convergence in capital requirements, as among like classes of activities in banks and other financial entities;
  - the creation of an interagency "Financial Services Oversight Board" to insure, among other things, that a uniform definition of financial services is applied to all classes of banking and financial entities;
  - that component parts of bank, thrift and financial holding companies would be subject to direct institutional supervision in much the same fashion as is the case today but against a set of functionally based prudential and customer protection standards; and
  - that any financial organization that has access to the discount window and is a major user of the large-dollar electronic payments system would be subject to a degree of consolidated supervision by the Federal Reserve.

- Fifth, taken as a whole, the proposals provide for a high degree of choice or "volunteerism" on the part of individual business enterprises. That is, any firm that wishes to be in the business of providing banking or financial services has clear options available to it depending on how that firm weighs the costs and benefits of one corporate form versus others. Beyond that, and within each major category of enterprise, the firm would have considerable discretion—subject, of course, to appropriate regulatory restraints—to choose the specific types and forms of services it might wish to provide. And it would also be possible for firms to shift from one category to another, recognizing, of course, that a bank or financial firm that was acquired by a commercial firm or that chose to enter commercial lines of business would have to divest any depositories it owned.

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While all of the above considerations are important, the acid test of the approach is whether it would work in the direction of reducing systemic risk while at the same time leaving ample room for market discipline to play its necessary and appropriate role Insofar as the stability of the system as a whole is concerned, there are several aspects of these proposals that clearly work in the direction of reducing vulnerabilities For example.

- the narrowing of artificial distinctions among classes of financial institutions would work in the direction of reducing inhibitions on the regulatory side in calling for stronger prudential standards in such areas as capital adequacy,
- the incentives to move activities offshore or to the point of least supervisory purview would be reduced,
- the payment of interest on demand deposits and reserves would reduce the incentives for intraday and day-to-day churning in financial markets,
- the liquidity reserve would increase the cushion of cash balances in the system, thereby reducing intraday credit exposure and providing a thicker liquidity cushion—short of the central bank—for individual institutions and for the system as a whole;
- more open access to the payments system and finality of payment in large-dollar electronic payments systems would reduce the systemic risks in the payments system while also working in the direction of isolating problems at their source, which in turn would provide a degree of greater flexibility in official responses to problems if and when they arise, and
- providing for a degree of consolidated supervision of diversified financial firms would appreciably narrow a major gap in the official supervisory network.

In considering the factors outlined above, the most difficult question is not whether they will work in the direction of strengthening the system but rather whether they might work too well. By that, of course, I mean that there is always a danger that they will be perceived merely as extending the "safety net" and thus running the risk that the result will be a further erosion of discipline in the marketplace, since market participants may conclude that the safety net will protect not just the system but all of its component parts, even those who have acted in an irresponsible or undisciplined fashion.

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As I said earlier, that perception, to the extent it does or might exist, must be changed. To repeat, the freedoms contemplated by the current market environment must include the freedom to fail. And, by extension, the financial system must be a system in which discipline operates through prior restraints—saying "no" to unduly risky activities and transactions—and not by falling into situations in which restraint and discipline are achieved only as a by-product of instability and failure

The separation of banking and commerce

While the current debate regarding reform of the banking and financial system has many controversial aspects, one source of debate that is especially crucial to the deliberations of the Congress relates to whether, as a matter of public policy, we should preserve a separation between banking and commerce

I have spent countless hours deliberating the wisdom of maintaining the separation of banking from commerce Having done that, I can say, Mr Chairman, that if my views have changed, they have changed in the direction of further solidifying my judgment that it is in the public interest to have a legislative framework that

prevents commercial firms from owning and controlling banks unless there is some absolutely compelling reason to permit such combinations. Since I see no such compelling reason at this time, I remain opposed to such arrangements.

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

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

The central question at issue with respect to the banking-commerce separation doctrine is whether it is desirable for wholly unregulated, unsupervised commercial concerns to be able to own and control depositories having access to the overall Federal financial safety net.

- Second, the central question at issue with respect to the banking-commerce separation doctrine is whether it is desirable for wholly unregulated, unsupervised commercial concerns to be able to own and control depositories having access to the overall Federal financial safety net. In seeking to answer the question we should, for starters, keep in mind that if we in the United States go that route, such arrangements would be unusual among the industrial countries of the world in that in no other major countries are banks, as a general matter, owned and controlled by commercial companies. To be sure, in some countries, such as Germany, banks have greater flexibility in the extent to which they may hold equity interests in commercial companies than is the case in the United States, but commercial ownership and control of banks are not common
- Third, if, as a legal matter, commercial concerns are able to own and control banks, it seems apt to ask would they choose to do so, and if so, why? To some extent we know the answer to the first question, since at least some commercial firms already own insured depositories and others seem to have an interest in doing so. In that setting, the operative question is why they would wish to do so. Here there can be only three possible answers. First, among the alternative uses of capital, they visualize the relative returns available in banking as superior; second, they see synergies in the combination of banking with existing lines of business that will permit them to maximize the overall return on capital; or, third, they see economic advantages in gaining access to one or more of the privileges associated with banking, such as access to the market for insured deposits or direct access to the payment system. Of course in reality, the motivation might well reflect some combination of the above factors. The key point, however, is that if the motivation for commercial companies to own banks is even partly related to the second and/or third explanations cited above, there are clear dangers in permitting such combinations.
- Fourth, one might be more inclined to run those risks if there is some absolutely compelling public policy reason to do so. Satisfying the business interests of a relative handful of corporations does not strike me as a compelling public purpose. On the other hand, if there was (1) strong evidence of an absence of competition in banking or (2) strong evidence that combinations of banking and commercial concerns would unleash powerful new economies of scale which did not run afoul of public interest considerations, or (3) if the banking industry was suffering a chronic shortage of capital, one would look at banking and commerce in a different light.

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

which is the very source of my concern.

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

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

Taking all of those considerations into account, there are two major classes of risks that must be considered if we are prepared to permit the blending of commerce and banking. The first set of risks are the historic concerns about concentration, conflicts, unfair competition and breaches of fiduciary responsibilities. Interestingly enough, even most proponents of blending banking and commerce acknowledge that those risks are present. In response to this, the proponents suggest that the problem can be dealt with by regulation. However, if regulation is effective, it will, by definition, eliminate the synergies of any such combination such that the commercial firm in question is left only with a truly passive investment. If that is the objective of the commercial firm, there is nothing to prevent such firms from making large equity investments via the open market in any number of banking or financial entities so long as any one such investment does not achieve control over the company in question. Indeed, a commercial firm can buy up to 5 percent of the stock in any one bank without even having to disclose such an investment.

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

At the extreme, the logic of the matter is unavoidable; if the bank cannot be fully insulated from the entity as a whole, the consequences are either (1) the safety net surrounding banking will have to be extended—at least to an extent—to all who would own and control banks, or (2) the safety net should be eliminated altogether.

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

Therein, of course, lies the dilemma; that is, even the official act of approving an application of a commercial firm to acquire a bank seems to carry with it the extension of at least some elements of official oversight

to the acquiring firm in a manner that brings with it—at least by implication—an official blessing of the transaction and the relationship in question. As I see it, this subtle but certain extension of the safety net is not something we should take lightly since we must be prepared to live with the consequences in foul weather as well as in fair. Indeed, at the extreme, the logic of the matter is unavoidable; if the bank cannot be fully insulated from the entity as a whole, the consequences

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Supervisory considerations

In concluding, allow me to make a few brief comments on supervisory considerations most of which are discussed in greater detail in my essay.

- First, while there is a strong case for regulatory reform in banking and finance, it would be counterproductive to seek to legislate such reform until we know how the structure of the system itself will evolve, legislatively or otherwise.
- Second, if a financial structure reform proposal along the broad lines I have suggested were to be put in place, only relatively minor changes in the regulatory apparatus need accompany that process in the first instance.
- Third, I believe that legislation aimed at simplifying and streamlining the administrative and related procedures of the Bank Holding Company Act along the lines included in S.2858, which was passed by the Senate in September 1984, is an important priority in its own right. Indeed, these provisions, especially in a context in which product and service options for banking organizations were broadened, would greatly ease regulatory tasks for banks and for the Federal Reserve alike.
- Fourth, I strongly believe that major banking or financial firms—especially those having direct access to the central bank's payments, liquidity and credit facilities—should be subject to at least a degree of consolidated supervisory oversight by the central bank. Indeed, even with a strengthened Section 23A of the Federal Reserve Act, the nature of intra-company transactions and interdependencies is such that a degree of consolidated supervision of the entity as a whole strikes me as an essential component of any well-designed supervisory apparatus.
- Finally, banking and financial supervisory policy is going to have to move faster and further in the direction of international convergence but also in the direction of insuring that like activities are subject to the same capital and other prudential standards, regardless of where in a corporate entity those activities are conducted or booked.