Reforming the U.S. Financial System: An International Perspective

Good morning, Mr. Chairman. It is a pleasure to appear again before this Committee to discuss the pressing issues facing the U.S banking and financial system and to stress the need to promptly enact broad-based legislation that would reform and modernize the structure of the U S. financial system and many features of the supervisory arrangements associated with the operation of that system. As has been the case in the past, I want to state at the outset that the views I will express today are my own and, as such, they should not be construed to reflect the views of the Federal Reserve Board or the Federal Reserve System as a whole.

While I will, over the course of my remarks, address all of the issues raised in your letter of invitation, I intend, for the purpose of orderly presentation, to consider these issues in a different sequence than outlined in your letter, starting with the international side of the equation. Since the scope of the material to be covered this morning is very broad, I have attached to my statement a number of appendixes which I hope will be of value to the Committee and its staff in the effort to gain a broad perspective on the complex set of issues bearing on how we can best adapt the structure of the U.S. financial system over time.

Banking and financial structure abroad

The legal and institutional framework within which banking and financial systems operate in the major foreign industrial countries is of importance to the United States for a variety of reasons. Two are particularly relevant in the immediate context of this hearing. first, international differences in banking structure can have important implications for the competitiveness of U.S. institutions both here in the United States and around the world; and second, international differences in financial structure can introduce complex and potentially dangerous elements of tension into cross-border relationships as they pertain to the rights and privileges of banks and other financial firms to operate across national boundaries.

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In order to provide the Committee with an overview of these structural arrangements abroad, the first appendix to this statement provides a broad — and admittedly oversimplified — summary of banking structures in the Federal Republic of Germany, Japan, and the United Kingdom as well as a brief description of the main thrust of the Second Banking Directive that will govern banking activities in the European Community. While I will not repeat the thrust of that appendix, I would stress the following major points:

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, May 3, 1990 The appendixes referred to in this statement are available upon request from the Public Information Department of the Federal Reserve Bank of New York

- First, as a rough approximation, financial structure in the United Kingdom is quite similar to the financial structure in other countries with close historic ties to the United Kingdom such as Canada and Australia.
- Second, the prevailing structure in West Germany is very similar to that in the Netherlands and Switzerland and, to a somewhat lesser extent, other industrial countries in continental Europe such as France and Italy

Looked at in that light, there are, as a rough approximation, three operational models of banking structure in the industrial world today, as follows.

- First, the West German–style universal bank in which the full range of banking and financial services is provided within a single legal entity. There is no holding company, and separate subsidiaries are used only at the convenience of the bank or when required by foreign regulatory authorities for particular activities conducted outside of Germany. In most universal banking countries, banks may, and often do, own sizable equity stakes in commercial concerns, but the opposite is generally not the case. In other words, manufacturing and other nonfinancial firms do not typically own and control banks. In this regard, it should also be said that in Germany the practice of banks owning large equity stakes in commercial firms has been the subject of lively political debate from time to time and the subject of renewed debate in the recent past.
- Second, the British-style universal bank, which differs from the German model in that (1) separate legal subsidiaries are more common, (2) bank holding of shares of commercial firms is far less common, and (3) combinations of banking and insurance firms are far less frequent — at least to date. But the operational character of the United Kingdom–style universal bank has much more in common with the German-style model than it does with arrangements here in the United States — a pattern which will be magnified when the EC banking directive becomes operational.
- Third, the fragmented systems such as currently prevail in the United States and Japan In these models there are, of course, rigid legal and operational distinctions between classes of financial institutions, including but not limited to the separation between commercial and investment banking. However, even between the U.S. and Japanese systems, important differences exist — for example, the fact that holding companies do not exist in Japan and, in fact, are strictly forbidden by law. It should also be noted that some would suggest that the Japanese system shows some signs of moving toward a British-style universal bank, at least for wholesale banking, securities, and other financial services.

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With that general description of the three prevailing models in mind, let me now turn to the major differences between the U.S. system and systems in the major industrial countries abroad. Placing aside supervisory issues, which I will come to shortly, the major structural differences are as follows:

- First, the bank or financial services holding company is unique to the United States. This is not an incidental difference when it is remembered that in this country such holding companies are almost always the financial and managerial nerve center of the entity as a whole. Abroad, those crucial functions — including the all-important point of access to capital markets — are almost always housed directly in the lead bank or lead financial institution itself In this setting, even sophisticated foreign market participants *and officials* often have a great deal of difficulty understanding structural arrangements here in the United States — a situation that was amplified by the recent Drexel episode

The United States is the only major country that does not have a true national banking system. While state initiatives are materially reducing the barriers to national banking in the United States, even after state initiatives have run their course, we will still be left with a crazy-quilt pattern of state and federal laws and regulations governing various aspects of interstate banking.

- Second, the United States is the only major country that does not have a true national banking system. While state initiatives are materially reducing the barriers to national banking in the United States, even after state initiatives have run their course, we will still be left with a crazy-quilt pattern of state and federal laws and regulations governing various aspects of interstate banking Such arrangements in this country will stand in increasingly sharp contrast to the situation in the rest of the world, and especially relative to Europe, once the new banking directive takes hold and all duly licensed banking entities—including subsidiaries of U S banking and securities firms—will be freely able to provide a full range of banking and financial services across the national boundaries of the twelve countries making up the European Economic Community. No small wonder, therefore, that prominent officials in Europe have some difficulty understanding the restrictions placed on the scope of geographic and product opportunities available to European institutions operating in the United States

- Third, with the sole exception of Japan—and that will almost surely change in time whether or not we change—the United States stands out as the only country with a fragmented banking system that severely limits or restricts the type of *financial* products and services that can be offered by particular classes of institutions. Once again, and leaving aside what changes may occur in Japan over time, the comparative situation in the United States will only get worse when the banking directive becomes operational in Europe

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While these differences in structure are important, they become all the more important in the face of related differences in supervisory or so-called safety net arrangements in the other major industrial countries In contrasting such arrangements in the United States with those in other countries, there are some striking differences. The most important of those differences are as follows

- First, in every other country studied, consolidated supervision of mainstream banking and financial companies is the rule—without any exception that I am aware of. It is obviously the case with the German-style universal bank; it is unambiguously the case in practice in the United Kingdom, and it is the case in Japan, even in the face of Article 65 Moreover, in the few cases where commercial companies own banks—such as in France or Italy—the supervisory process pierces the "corporate veil" between the bank and the commercial company owning and controlling the bank. Maybe my friends and associates abroad tell me what they think I want to hear, but what they often say is that they are bewildered by those supervisory arrangements in the United States that do not rely on the principle of consolidated supervision.

In every other country studied, consolidated supervision of mainstream banking and financial companies is the rule—without any exception that I am aware of.

- Second, while twenty years in this business has taught me that there are no absolutes, the fact of the matter is that in no case that I have been able to discover are there firewalls in mainstream foreign banking firms that would routinely—but especially as a matter of law—restrict flows of funds and capital among affiliated entities within the same financial group except in extraordinary circumstances My tendency to reject absolutes tells me there must be exceptions to this But if there are, they are not prominent. For example, the absence of such firewalls is obviously the case for universal banks, but it is also the case within financial groups or firms in the United Kingdom, Japan, and elsewhere That is not to say that strict regulations governing certain intracompany activities aimed at customer protection, competitive equality, and the facilitation of what we would call functional regulation do not exist, for surely they do exist. Rather, it is to say that in all major foreign countries studied, issues of liquidity and solvency are viewed at the level of the firm as a whole by both regulators and market participants. Thus, firewalls that wholly preclude or limit the flow of funds or capital within the firm are viewed as either unnecessary or counterproductive, except in extraordinary cases when they are imposed by the authorities in an effort to exercise "damage control."
- Third, in all of the countries studied, mainstream banking organizations as a whole—including their securities affiliates—have direct or indirect access to the payment, account, and liquidity facilities of their respective central banks Indeed, even in Japan with its Article 65 separation of commercial and investment banks, the major securities firms

have accounts at the Bank of Japan as well as access to its discount window in exceptional circumstances. These global arrangements, among other things, reflect the implicit or explicit recognition that central banks have a unique role and responsibility to help safeguard the effective functioning of financial markets and institutions in order to help guard against disruptions that might have systemic implications

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- Fourth, in the area of deposit insurance, all of the countries studied have deposit insurance systems that have some similarities — but some important differences — compared with the system of deposit insurance in the United States. The most important similarity is that all such systems studied have formal or legal limits stipulating that only deposits up to a certain size are insured. The most important difference is that, as a rough approximation, appearances would suggest that the private sector has a larger role in the operation and administration of deposit insurance schemes in foreign countries than in the United States, and as a result, the *direct linkage* to the full faith and credit of the government may be less explicit than is the case in the United States.

From the above, one might be tempted to conclude that in foreign countries depositors are, in de facto terms, less protected than they are in the United States, or more broadly, that foreign banking and/or financial firms are somehow less "protected" and therefore subject to a greater degree of "market discipline" than is the case here in the United States In order to gain some insights into these and related questions, the next section of this statement looks at some concrete examples of the workings of the so-called safety net in other countries.

The workings of the safety net abroad: some case studies

In order to gain some useful insights into the de facto workings of the safety net in other countries, I asked several of my colleagues at the Federal Reserve Bank of New York to research experience in that regard with respect to a number of highly visible cases of troubled financial institutions in foreign countries that have occurred over the past twenty-five years. The results of their work are summarized in Appendix II. Undertaking this effort was not easy, because in all such instances my associates relied essentially on publicly available information and data. While this approach has its limitations, it is also true that this information is that which market participants must use in assessing how the authorities will behave. On the other hand, this approach of course implies that factual details, but especially judgments about motivation, may not always be entirely clear Yet for the purposes at hand, even the broad sweep of events surrounding these cases provides a useful insight into the de facto working of the safety net in other countries Moreover, beyond these case studies, I have from time to time informally discussed this general subject with many of my colleagues in the major foreign central banks. On the basis of both the more formal research and impressions gained in discussions with officials abroad, I would draw the following conclusions concerning the de facto operation of the safety net in major foreign countries

- First, with the sole exception of the Herstatt failure in 1974, I am unable to find *any* case in which the authorities have been willing to permit the sudden and disorderly failure of an important banking or nonbanking financial institution (As I will indicate below, the meaning of the word "important" in this context *clearly* is not limited to size.) Indeed, the experience with Herstatt and its long and painful aftermath seem to have provided the authorities in all countries with a lasting impression of the grave dangers associated with the sudden and uncontrolled collapse of an important financial institution, especially one with significant — although again not large by today's standards — international operations.

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- Second, notwithstanding the presence of legal or formal limits on the extent of deposit insurance coverage, authorities in *all* foreign countries have, as a matter of general practice, gone to considerable lengths to protect depositors from loss. Indeed, my overall impression is that the number of instances in which depositors—*large or small, insured or not*—have incurred actual losses are few and far between. And where they have occurred, they have been limited to isolated cases or to cases in which the depositors had other relationships—such as being shareholders—with the failed institutions. Having said that, I should quickly add that we have never seen anything abroad even remotely approaching the scope of the thrift industry problem, although the U.K. secondary banking crisis had many structural characteristics in common with the thrift problem in the United States.

- Third, in a number of prominent cases, some covered in the appendix and some not, the authorities, including central banks, have moved swiftly and decisively to intervene in the cases of troubled *nonbank* financial institutions—here too, some conspicuously small in size. Such interventions have involved the use of central bank credit facilities, public monies, and at times a degree of moral suasion, if not arm twisting, that, from my experience, simply would not work in the United States.

  In all such cases, public intervention was apparently motivated by concerns about systemic risk, but as suggested above, in several instances the troubled institution was not particularly large and in other cases was distinctly "nonbank" in character.
- Fourth, in a number of prominent cases, again some covered in the appendix and others not, the "rescue" efforts undertaken by the authorities entailed a joint effort with public and private entities. Indeed, at the risk of overgeneralization, it seems fair to say that the foreign official institutions seem better able to call upon, if not insist upon, the participation of private entities in such rescue operations than is the case in the United States. In a number of cases, though, including the silver market crisis in 1980, the LDC debt crisis, the Continental Illinois Bank problem, and the 1987 stock market crash, joint public and private actions were very much in evidence in the United States. Nevertheless, my impression—unscientific as it is—remains that private institutions either are more willing or feel more compelled to participate in stabilization or rescue efforts in foreign countries than they do in the United States.

  If that impression is correct, it raises the obvious question why private foreign financial institutions play a larger role in such rescue operations than is the case in the United States. Here one can only speculate that part of the answer may simply lie in history: that is, it has been done that way for many, many decades. It may also be true that where a handful of banks dominate national banking systems, that handful of banks feel more directly threatened by potential dangers of a systemic nature than do institutions here in the United States. Finally, when the headquarters of that same handful of banks are typically located only minutes away from the central bank, and when so few must agree on a particular course of action, it is obviously much easier to bring things together than it is here in the United States. For example, there is some substance to the suggestion that one of the most potent tools available to the Bank of England in time of stress is the Governor's eyebrow!

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In summary, experience abroad suggests that authorities in foreign countries behave in a manner very similar to the authorities in this country when faced with problems in financial institutions. If anything, the protections provided by authorities abroad seem, on balance, to go further than might reasonably be expected in this country. This, of course, is another way of saying that institutions in this country are subject to at least the same—if not a greater—degree of market discipline than is the case abroad.

Yet it seems clear to me that over the past fifteen years, the United States has had more than its share of banking and financial market disruptions. In those circumstances, a question naturally arises why we have had, in relative terms, so many such disruptions in recent years.

Given the experience in other countries, it is very hard to make the case that the de facto operation of the safety net in this country in and of itself is accountable for the problems and strains in our financial system.

For many, the answer to that question comes easily: too big to fail, de facto full insurance of deposits, overextension of the safety net, not enough market discipline. While there is some truth in all of these generalizations, the answer clearly is not all that simple. One thing, however, strikes me as quite clear: namely, given the experience in other countries, it is very hard to make the case that the de facto operation of the safety net in this country in and of itself is accountable for the problems and strains in our financial system. Even greater market discipline may be needed, but the evidence as a whole suggests that there is something much more fundamental at work.

To complete the analysis of the international side of the equation, one more piece of the puzzle must be put in place. That piece, of course, relates to the international competitiveness of U.S. banking and financial institutions.

The international competitiveness of major U.S. financial institutions

In recent times, the subject of the international competitiveness of U.S financial firms has received increasing attention. In order to shed some further light on this subject, my associates at the Federal Reserve Bank of New York have been engaged in an effort to analyze more systematically both the myths and the realities of this situation. As a part of that effort, I have attached to this statement as Appendix III a paper summarizing the results of some of this work That paper provides a summary of selected performance traits of a cross section of fifty-one major and internationally active banking and securities companies from seven major industrial countries. Before I attempt to summarize the results of this analysis, allow me to emphasize a number of qualifications about these data and the delicate task of drawing reasonable and reasoned conclusions from the data:

- First, due to substantial differences in regulatory, accounting, and tax rules in the respective countries, many of the cross-border comparisons are seriously distorted if taken at face value. Indeed, to properly interpret the data, one must have at least a general sense of these accounting and related differences in order to have the proper perspective on the various statistics To cite just an example or two
  - —I know that the underlying capital position of one or more groups of foreign banks is a good deal stronger than the raw statistics would suggest, in part because accounting rules and tax rules allow some groups of banks a great deal of flexibility with regard to the accounting for, and accumulation of, so-called hidden reserves.
  - —I know that the statistics on profitability are seriously distorted—perhaps more so than any other grouping of these data—in a way that tends to understate the "core" profitability of U S. banks relative to one or more of the other groupings of national banks.
- Second, even aside from data problems, the information contained in this appendix is limited in the extent to which it provides decisive insights into the international competitiveness of one national group of banks versus others. In part this is true because of certain individual institutions in this country and abroad that stand out to such an extent from their domestic peers that they seem to defy these international comparisons.
- Third, under the best of conditions, aggregate performance data at the level of the individual firm tell only a part of the story. Accordingly, my associates are also seeking to investigate international competitiveness of U S. firms in a number of specific but discrete markets, ranging from foreign exchange and interest rate swap markets to retail banking This is of course a very difficult undertaking but the initial impression one gets from this line of approach is that U.S. financial institutions continue to be seen in the markets as strong and imaginative competitors in many individual product and service lines, especially in the more sophisticated and innovative areas This work has a long way to go, but if it is successful, we will find an appropriate vehicle to make the results public sometime late this year or early next year.

With those qualifications in mind, my personal interpretation of the data and information contained in Appendix III leads me to the following main conclusions

- First, on balance, I would place the U S. banks somewhere roughly in the middle of the pack of the national groups of banks studied in terms of all the performance measures studied
- Second, looking at U S banks and securities firms combined, relative to the German-style or British-style universal bank or relative to the combination of Japanese banks and securities companies, I would be inclined to a similar "middle-of-the-pack" or perhaps slightly weaker relative ranking of U S institutions
- Third, while hindsight in this regard is far from twenty-twenty, my strong hunch is that a similar exercise performed ten or twenty years ago would have provided a result in which the rankings of U.S. firms would have been higher and perhaps materially higher In other words, while the data may suggest that U.S. firms are still quite capable of holding their own in an international context, there is no doubt in my mind that as a group their position has slipped

Before I turn to the final two sections of this statement, allow me to summarize its main points thus far. First, the basic structural *and* supervisory framework governing the operations of U.S. banking and financial firms is materially different from that in all other countries studied and, as things now stand, will become increasingly so in the foreseeable future. Second, despite sharp differences in key elements associated with the structure and design of the so-called safety net, the de facto operation of the safety net—including the extent of depositor protection—appears quite similar across the industrial countries. If anything, market discipline may, on balance, play a larger role in this country. Yet over the past fifteen years, the United States has had more than its share of banking and financial disruptions, therefore casting some doubt on the oft-cited proposition that these problems have as their *basic cause* the tendency for authorities in this country to bail out troubled financial institutions. Finally, the analysis of the international competitiveness of U.S. financial firms places such firms somewhere in the middle of the pack, a position that almost surely reflects a deterioration in standing from ten or twenty years ago.

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Of the many questions raised by these interim conclusions, two stand out: first, if the de facto operation of the safety net is quite similar across countries, why have we in the United States witnessed what strikes me as a disproportionate number of financial disruptions in recent years, and second, what accounts for the less than strong overall performance of U.S. firms in an international setting, especially if, as I believe, that performance has slipped in the last decade or more?

Underlying factors influencing the performance of banking and finance

At the risk of great oversimplification, it seems to me that there are five major reasons that we see a U.S. banking and financial system characterized by the dual conditions of recurring bouts of instability and competitive slippage both at home and abroad.

- The first major factor that is helping to shape these trends in the banking and financial sector—especially in a comparative international context—is macroeconomic performance and policies. Over the last decade and a half, volatility in GNP, high and volatile rates of inflation, low savings, and our weakened external position have all contributed to a financial environment that breeds difficulties at home and contributes to slippage abroad. With regard to the latter, there is simply no question in my mind that one of the key reasons for the emergence of the Japanese financial institutions as so large a force in global markets is rooted in Japan's strong overall economic and financial performance over much of that period.

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- Second, for a variety of reasons—many rooted in technological advances in telecommunications and in the information sciences—the historic value of the banking franchise is under great pressure. The institutionalization of savings, the securitization of financial assets and liabilities, the easy access to information about creditworthiness of individual borrowers, and even the "800" telephone number are all symptomatic of a rapidly changing banking and financial environment that has unquestionably undercut the once considerable value of the banking franchise. This tendency is reinforced by the fact that due to these same technological and informational factors, the "shelf life" of most innovations in banking and finance is very short in duration.

  As one reflection of this, the most creditworthy corporate borrowers can now fully bypass the entire banking and financial system for many of their day-to-day credit needs. For example, we now have instances in which firms with particularly strong credit ratings are able to place their own commercial paper directly with institutional and other investors, thereby bypassing not only the commercial banking system — once the exclusive source of such short-term credit — but also the underwriting and placing capabilities of the investment banking industry. Now that is disintermediation!

As another, more recent example, AT&T — with its vast financial and technological resources — has recently entered the credit card business and in the process is offering consumers very attractive terms on such cards in a context in which there would appear to be potentially very considerable synergies between this line of business and AT&T's traditional lines of business.

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The diminished value of the banking franchise in this country appears, for a variety of reasons, to be somewhat more advanced than is the case in other countries — although that may not last For example, capital markets are not nearly as well developed in Japan as they are in the United States, the result being that the role of the deposit intermediary is still more central in Japan than it is in the United States. Some would also suggest that the very close relationships between banking and large industrial firms in other countries work in the direction of helping to preserve the banking franchise Finally, some would also suggest that the authorities in other countries may tilt a bit in the direction of trying to preserve the value of the franchise where that is possible.

In suggesting that the value of the banking franchise has declined, I am not suggesting that the developments that have given rise to this situation are all bad. To the contrary, most of them are very good in terms of efficiency, reduced costs, greater competition, and vastly increased choices for savers and investors. But taken as a whole, these developments have clearly and irreversibly changed the rules of the game in a manner that, at the very least, makes for difficult transitional problems for the affected institutions and markets.

- Third, partly because of the competitive implications of the technological and market forces described above and partly because we have so many financial institutions and so many classes of financial institutions that compete with each other, we now have, in my view, excess capacity in large segments of banking and finance This same condition appears to exist internationally, at least in some segments of wholesale markets The symptoms of this condition abound in razor-thin spreads and pinched margins, and perhaps especially in the troublesome manner in which we see vast amounts of very short-term churning and trading in so many segments of the financial markets. As I have said on other occasions, this situation seems at times to create a vested interest in volatility, since opportunities for trading profits at the level of the individual firm or individual trader seem greatest when swings in interest rates and exchange rates are also the greatest. Whatever else one can say about this, it reinforces the unrelenting preoccupation with the short run we see in financial markets and in corporate America more broadly.

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What may be even more important, however, is that if my conjecture about excess capacity in financial services is correct, it would clearly imply that we will have to go through a period of at least some consolidation in banking and finance. In saying this, I am not suggesting for one minute that we will end up with a highly concentrated banking and financial system along the lines of what we see in many other countries. The trick, of course, is to shape public policies in a manner that provides the highest assurance that the process of financial market consolidation in the United States occurs in an orderly and equitable manner consistent with broad national goals and priorities

- The fourth factor I would cite in this regard is the direct subject of these hearings namely, the outdated legal and institutional framework within which the U.S banking and financial institutions operate As the first section of this statement makes clear, the U.S. banking system is simply out of step with the rest of the world, and more important, it is out of step with the realities of the marketplace Even more important, the system as now configured may be risk and accident prone rather than risk adverse. Fragmentation alone may produce that result since fragmentation can inhibit diversification of risks on both sides of the balance sheet. Similarly, the inescapable tendency of firms and market participants to push the spirit and the letter of law and regulation to the limit in a fragmented system brings with it its own elements of risk and perversity Finally, fragmentation inevitably brings with it the tendency to shift activities offshore, which in turn entails loss of income, loss of jobs, and in some cases the loss of some element of managerial and supervisory control.

- A final factor I would cite that bears particularly on the relatively high incidence of financial disruptions in this country is what are often called gaps or lapses in the supervisory process. The most important illustration of this, by far, is to be found in the thrift industry situation, which was far, far more a fatal flaw in the legal and supervisory process than a flaw in the architecture of the deposit insurance system. More generally, I believe at least something of a case can be made that the highly fragmented nature of the U.S. banking and financial system may, in its own right, contribute to gaps in the supervisory process.

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In considering all the factors cited above, note that for the most part they are secular in nature and, as such, reflect "outside" forces impacting on the environment within which banking and financial institutions operate. However, one should not conclude from this that all of the elements that have produced strains in banking and finance are of this nature For example, there are internal forces—such as the current problems in real estate markets or the overhang in the market for high-yield securities—that importantly reflect a lack of prior restraint on the part of some market participants. Similarly, we have seen all too many instances of poor management, overly aggressive strategies, and unfortunately, elements of highly questionable behavior, including some outrageous instances of outright criminal activity

But problems growing out of poor management, recklessness, or even illegal activities—outside of the thrift industry problem—are relatively few in number, although at times highly visible in nature Moreover, existing regulatory and legal sanctions can probably cope with these problems, especially with the strengthened provisions in the Financial Institutions Reform, Recovery and Enforcement Act The more generalized situation having to do with the competitive well-being and the underlying stability of the banking and financial system must be looked at in the broader light of the other issues raised in the earlier parts of this statement.

Reform and modernization of the U.S. banking and financial systems

In approaching the reform and modernization of the U S. banking and financial system, this Committee and the Congress as a whole can, as I see it, choose among four basic alternatives or models (1) the current fragmented system, (2) the German-style universal bank, (3) the British-style universal bank, or (4) the financial services holding company approach along the broad lines suggested in my 1987 essay, *Financial Market Structure: A Longer View* For my part, I would quickly rule out the status quo and the German-style universal bank. In the latter case, I would come to that conclusion because of my discomfort about the nature and extent of the "banking-commerce" linkages that the German-style universal bank seems to imply.

In approaching the reform and modernization of the U.S. banking and financial system, this Committee and the Congress as a whole can, as I see it, choose among four basic alternatives or models: (1) the current fragmented system, (2) the German-style universal bank, (3) the British-style universal bank, or (4) the financial services holding company approach along the broad lines suggested in my 1987 essay.

In a consideration of the relative merits of the financial services holding company versus the British-style universal bank, there are three major areas of potential difference—aside from supervisory arrangements, which will be considered later. Those areas of difference are (1) the definition and scope of financial activities that can be conducted within the group or company, (2) the presence or absence of the holding company itsel , keeping in mind that these holding companies are, in a U S context, the financial and managerial nerve center of the company as a whole, and (3) the nature and extent of the rules and regulations limiting or preventing various classes of transactions or other relationships between the various component parts of the entity as a whole — that is, Chinese walls and/or firewalls While it does not necessarily follow, there may also be differences as they relate to whether and under what conditions the entity or its parts may have access to the account, payment, and liquidity facilities of the central bank.

In choosing between these two alternatives, I would still have a preference for the financial services holding company, particularly given where we are as a nation in terms of the evolution of our attitudes on these matters. Having said that, if I had the liberty of starting with a clean slate, I might well opt for the British-style universal bank. In either case, I strongly believe that the approach must be reciprocal along the broad lines of the philosophy of the Proxmire-Garn bill. That is, for example, if banks can get into the securities business as a general matter, securities companies — with some possible exceptions — can get into the banking business In the case of either model, I also believe that

There must be strong Chinese walls that provide protections against conflicts of interest, unfair competition, and certain kinds of "tie-ins." Similarly, I believe there should be reasonable protections against undue concentrations.

there must be strong Chinese walls that provide protections against conflicts of interest, unfair competition, and certain kinds of "tie-ins." Similarly, I believe that there should be reasonable protections against undue concentrations, recognizing, of course, that some consolidation in banking and finance will occur under any circumstances Finally, I believe that there must be an instrumentality that would be responsible for the ongoing task of defining and limiting the scope of activities that can be conducted in the group as a whole.

I believe with more conviction than ever that we must have a system of consolidated supervisory oversight of any company that has direct or indirect access to the "safety net."

There are, however, three areas in which my personal views may place me somewhere between a distinct minority and a voice in the wilderness — and probably closer to the latter. They are

- First, I believe with more conviction than ever that we must have a system of consolidated supervisory oversight of any company that has direct or indirect access to the "safety net" To me, the minimum that this entails includes (1) systematic reporting of financials for both on- and off-balance sheet activities at the level of the holding company and all of its subsidiaries and affiliates, (2) minimum capital standards, including those for the holding company level, and (3) standby authority for inspectors or examiners to do on-site reviews in any entity within the group, including the parent holding company.

  Where the dominant company is a banking entity, the Federal Reserve would be responsible for consolidated oversight Where the dominant firm is a securities entity, that task could be given to the Securities and Exchange Commission Functional supervision, much as we have it today, would apply to the component parts of the group as a whole.

  To me, the world we live in, together with the nature of the potential systemic risks we face in banking and finance, demands that we move in this direction. Some two and a half years ago, I summarized for this Committee the thinking that led me to this conclusion I have appended to this statement, as Appendix IV, an excerpt from that earlier testimony on this subject At this juncture, all I would add is that events since then, including the Drexel episode, have strengthened my views in this regard

I remain strongly opposed to the merging of banking and commerce and to any arrangements that would even remotely contemplate the ownership and control of bank holding companies or financial services holding companies containing depository institutions by commercial concerns.

- Second, I remain strongly opposed to the merging of banking and commerce and to any arrangements that would even remotely contemplate the ownership and control of bank holding companies or financial services holding companies containing depository institutions by commercial concerns Here too, on an earlier occasion, I spelled out before this Committee the reasons for my concerns in this regard, and I have provided an extract of that earlier testimony as Appendix V

  Notwithstanding the observations I made earlier about the diminished value of the banking franchise and the inroads of commercial firms into financial businesses, I still look with concern, if not alarm, at the economic, financial — and perhaps even social — implications of Exxon owning Chase Manhattan, Ford owning Citicorp, or RJR Nabisco owning J.P. Morgan. Obviously, those examples draw on more than a little hyperbole in order to stress the point But once that door is opened, there is absolutely no way to anticipate how events will shake out over time. Therefore, and absent that compelling public policy reason I spoke of in my earlier testimony, I would strongly urge that we maintain a strict separation of banking and commerce

It may be, in appropriate circumstances, that a case could be made that a margin of added flexibility could be provided whereby a bank or financial services holding company could own somewhat more than 4.9 percent of the equity of a nonfinancial concern and vice versa However, even this would have to be approached with care in view of the often razor-thin distinctions that now exist between various classes of "equity" and "debt" securities, keeping in mind that the issue here is not arithmetic but influence and control.

Similarly, some added flexibility might be considered where a bank or financial services holding company owns even a "controlling" interest in a nonfinancial firm so long as that latter firm is, in some sense, *de minimis* relative to the bank or financial services holding company as a whole. However, this too would have to be approached with great care, keeping in mind the extent of the problems that can arise, for example, with a seemingly *de minimis* real estate development company. The need for great care in this regard is strongly reinforced by case after case that illustrates that

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the well-being of the company as a whole cannot be safely disentangled from problems or adversities affecting an affiliated company, no matter how thick the firewalls nor how well constructed the legal separation. Indeed, in times of stress, not only does the marketplace fail generally to accept these distinctions, but the directors and managers of the firms under stress do not accept them either.

- Third, as suggested above, I have real worries about "firewalls" becoming "walls of fire" For these purposes, I want to distinguish between (1) "Chinese walls" — which, like regulations 23-A and 23-B, seek to protect against conflicts and unfair competition — and/or other such regulations governing "normal" business relations among affiliated companies, and (2) "firewalls," which strictly limit or prevent the mobility of funds and capital among affiliates My problem here is not with well-conceived "Chinese walls" but rather with ill-conceived "firewalls."

From a broad public policy perspective, the case for very thick and very high firewalls rests heavily on concerns about overextension of the safety net, threats to the deposit insurance fund and ultimately to the taxpayer, and the more subtle, but very important, moral hazard dilemma. Taken individually or collectively, these issues cannot be dismissed lightly.

Just as we cannot dismiss these concerns lightly, neither can we dismiss what the marketplace tells us both here and abroad And what the marketplace tells us with almost unfailing regularity is that in times of stress, some parts of a financial entity cannot safely be insulated from the problems of affiliated entities Investors, creditors, and even managers and directors simply do not generally behave in that fashion, and the larger the problem the less likely they are to do so Because this pattern of behavior seems so dominant and

There seems to me little doubt that taken to an extreme, absolute firewalls can aggravate problems and instabilities rather than contain or limit them.

because the authorities throughout the rest of the industrial world generally frame their policies with this in mind, there seems to me little doubt that taken to an extreme, absolute firewalls can aggravate problems and instabilities rather than contain or limit them Indeed, I do not have to stretch my imagination or my memory very far to find examples in which a heavy-handed approach to firewalls could easily have been the source of significant problems.

There is also a matter of logic here: That is, if we are prepared to accept the proposition that greater flexibility in allowing combinations of entities providing financial services makes sense, we must be saying, at least implicitly, that such combinations make sense on economic grounds. Otherwise the exercise is sterile. On the other hand, if we say such combinations are permissible but then insist on firewalls that are so thick and so high as to negate the economics of the combination in the first place, the net economic result will also be sterile

As with most things, the whole subject of firewalls has to be viewed in context. For example, in the context of an individual firm with very strong capital resources, presumably the case for firewalls is greatly diminished, if not eliminated. On the other hand, during a transition period in which financial structure is changing — especially if that process of change is accompanied by some consolidation — a conservative *interim* approach to firewalls may be quite appropriate. But even in those circumstances, I believe care is needed to ensure that we provide enough flexibility so that firewalls do not, in fact, become walls of fire

Safety net arrangements

As I see it, any discussion of the federal safety net associated with the banking system and individual banking institutions must start with the fact that such institutions are subject to a higher degree of regulation and supervision than is the case for most other kinds of private enterprise. While the specific points of emphasis of such regulation will vary from time to time and place to place, the basic rationale for such arrangements rests on two elements. first, the unique nature of the fiduciary responsibilities of such institutions, and second, the unique elements of systemic risk present in banking and finance While some bankers are not shy to complain about the burdens of some forms of regulation, all accept the premise as to why banks are regulated in the first instance. And most recognize that in exchange for carrying the burden of regulation, banking institutions enjoy certain benefits not normally accorded by markets or society to other classes of institutions For example, the mere presence of the supervisory apparatus is one of the reasons that the marketplace allows banking and financial institutions to operate with a higher degree of leverage than most other classes of institutions — a result that is seen as economically and socially desirable because of its capacity to help mobilize savings and investment and thereby foster economic growth and rising standards of living.

In addition, and in further exchange for accepting the burden of regulation, society conveys to banking organizations certain other direct benefits deposit insurance, access to the liquidity facilities of the central bank, and not least, access to the account and payment facilities of the central bank. The safety net must, therefore, be viewed as a package deal but one in which it is explicitly recognized that bankers — knowing that their business is essentially the business of public confidence — will conduct their affairs in a safe and prudent manner consistent with their fiduciary and societal responsibilities.

Looked at in that light, officially imposed prudential standards in such areas as capital adequacy, liquidity management, lending limits, and so forth — as well as the official examination process itself — are aimed in part at helping to establish an overall framework within which such institutions can compete and flourish but do so in a context that protects the safety and stability of the system as a whole. But — and this is a very large but — the first and foremost responsibility for the safe and prudent operation of individual institutions rests with the directors and management of those institutions — not with the authorities.

The safety net must, therefore, be viewed as a package deal but one in which it is explicitly recognized that bankers — knowing that their business is essentially the business of public confidence — will conduct their affairs in a safe and prudent manner consistent with their fiduciary and societal responsibilities.

Because the safety net by its very nature is a package deal, possible approaches aimed at improving the manner in which it functions must be viewed in that overall context For that reason, we must be careful about approaches that focus largely or exclusively on any one aspect or feature of the safety net to the exclusion of others. For example, while there are opportunities to improve the workings of the deposit insurance system, the deposit insurance system can only be as effective — and as cost effective — as the safety net as a whole, especially its supervisory components. Indeed, at the end of the day, I would argue that the broad approach to supervisory policy — including the examination process itself — is the foundation upon which an effective deposit insurance system must rest.

In the current setting, much of the debate about the safety net in general, and the deposit insurance system in particular, centers on wholly understandable concerns about the cost of bailing out troubled depository institutions. Within that context, there is a particularly sharp edge of debate about the school of thought that focuses on the suggestion that some institutions are too big to fail and the implications of that for the so-called moral hazard problem. In other words, how do we secure the right balance between market discipline on the one hand and protections against severe — if not systemic — disruption and dangers on the other, especially in a setting in which the business of banking and finance is subject to the enormous competitive and external challenges described earlier in this statement?

To my way of thinking, the most essential part of the answer to that question lies in the combination of private actions and supervisory policies that will strengthen the financial and capital positions of individual institutions, perhaps especially those institutions that by their size or character present the greatest risks to the stability and well-being of the system as a whole In this regard, it is perhaps worth noting that over the past decade we have, in fact, seen a material strengthening of the financial position of the largest banking organizations here in the United States

To illustrate this, I have included in the appendixes to this statement a series of charts depicting key indicators of the performance of the ten largest banking organizations in the United States over the past decade. In providing these data, I am mindful of the problem of having picked the ten largest as opposed to the twelve largest or the five largest or the twenty-five largest. I assure you, Mr. Chairman, the number ten was chosen only because it is a nice round number. Beyond that, it has no significance whatsoever. And if a different number were used, the results would not be affected in any material way

Taken as a whole, these charts capture rather well both the problems and the progress these institutions and the industry at large have experienced over the last ten years. They also capture the radically changed character of the banking business over the decade But perhaps more than anything else, they capture the very sizable *and very necessary* buildup in capital resources over the period. To cite just two examples:

I would argue that in the current environment, in which the domestic and international marketplace rewards strength, the competitive position of internationally active U.S. banking organizations would be improved as they move toward, and hopefully to the top of, the ladder in terms of their comparative capital strength.

— Since 1979, the absolute level of primary capital of these institutions has about quadrupled, reaching almost $80 billion at year-end 1989, while the primary capital ratios have about doubled.

— As of year-end 1989, the BIS tier-one risk-based capital ratios of these institutions are already well above the 1992 minimums, *using the more stringent 1992 definitions* of capital

In pointing to these data, I do not want to leave the impression that I am satisfied that all that needs to be done in strengthening the financial position of these and other institutions has been done, for it has not Indeed, in the current environment, all institutions should be working toward overall capital positions that are considerably in excess of regulatory minimums. Indeed, I would argue that in the current environment, in which the domestic and international marketplace rewards strength, the competitive position of internationally active U.S banking organizations would be improved as they move toward, and hopefully to the top of, the ladder in terms of their comparative capital strength.

Within the context of public and private initiatives that will continue to improve balance sheet and capital strength, the task of possible reforms of the deposit insurance system becomes far less formidable. Since the Treasury and the Federal Reserve are both looking into the subject of deposit insurance reform, I do not want to muddy the waters by getting into a bill of particulars on deposit insurance reform on this occasion. However, I will say that in my estimation the single most serious abuse of the deposit insurance system has been the misuse of brokered deposits. As a practical matter, fixing this problem without destroying the legitimate business of money and deposit brokerage will not be easy. In principle, however, what we should be striving for is a system in which the $100,000

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deposit insurance limit should apply per individual or per entity In mentioning this particular area of concern, I do not want to leave the impression that I am of the view that there may not be other constructive areas in which reforms might be considered That is not my view. But as I have stressed earlier, the first line of defense regarding the workings and integrity of the deposit insurance system lies in strong, well-diversified, competitive, and capital-rich depository institutions and in a strong, professionally staffed, and politically independent supervisory apparatus.

In this connection, we must also guard against the seductive appeal of "cookbook" approaches to problem institutions. With any troubled financial institution, but especially in the case of large institutions, I believe that the workings of both the safety net and market discipline will be better served in a context in which the authorities maintain a policy of what I like to call "constructive ambiguity" as to what they will do, how they will do it, and when they will do it. In saying this, I recognize that financial market participants do not like uncertainty, but that is just the point! Moreover, while I fully understand the yearning in some quarters for the cookbook approach to problems in financial markets or institutions—large institutions especially—I regret to say that in my judgment such a cookbook does not and never will exist. The circumstances associated with a particular case, the setting in which it occurs, and the assessment of the relative costs and benefits of alternative courses of action will always have to be looked at case by case. But in no case should it be prudent for market participants to take for granted what actions the authorities will take and certainly in no case should owners and managers of troubled institutions—large or small—conclude that they will be protected from loss or failure.

Conclusions

Mr. Chairman, my statement and its appendixes have covered an enormous amount of ground. In the interest of your patience I will not attempt to summarize at this time. But in conclusion, allow me to briefly stress three

With or without progressive legislation, the period ahead in banking and finance will not be easy. But with progressive legislation, our prospects are so much better for consumers, for businesses, for competitiveness, and perhaps most of all for the stability and soundness of our financial markets and institutions.

points. First, while I can readily understand why the thrift industry problem may have dampened the enthusiasm of the Congress to tackle the issues I have discussed today, it seems to me that the thrift industry problem tells us rather clearly that the longer a problem festers, the worse it becomes. With or without progressive legislation, the period ahead in banking and finance will not be easy. But with progressive legislation, our prospects are so much better for consumers, for businesses, for competitiveness, and perhaps most of all for the stability and soundness of our financial markets and institutions.

Second, over the course of my statement, I have deliberately stayed away from the subject of possible reforms in the structural arrangements associated with the supervisory system. I have done that because I firmly believe that such reforms should follow from reform of the banking and financial system—not precede it. But at the risk of appearing self-serving, I do want to repeat my utter conviction that when reform of the supervisory structure does occur, it should proceed in a manner that preserves a central—but by no means exclusive—role for the Federal Reserve. It seems to me that experience here and throughout much of the world tells us in rather certain terms that helping to ensure the safety and soundness of banking and financial markets and institutions and helping to stabilize such markets and institutions in the face of adversity are functions that relate directly to the very essence of central banks.

Finally, over the course of this statement, I have drawn heavily on experience and conditions in other countries. Having done that, I do not want to leave the impression that I feel any compelling case to duplicate precise arrangements in any other country or group of

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countries, because I do not. To be sure, we have some work to do in this country in adapting arrangements in a changing global setting; to be sure, we face some difficult transition problems in the period ahead, to be very sure, none of this will be easy. But as we face those challenges, let us not lose sight of our strengths: our financial markets are still the bellwether of world financial markets, our banks, investment banks, and insurance companies are still the leaders in constructive innovation, and our financial markets and institutions are still the world's safe harbor. Let us keep it that way!