Commentary on ''Proposals for Financial Restructuring''

Robert E. Litan

These are two excellent papers that span the spectrum of current economic thought about the wisdom of expanding the powers of banks or their holding companies. Despite their difference in perspectives, each paper significantly advances the level of debate over the restructuring of the financial services industries. I hope to demonstrate this as I briefly lay out for you how I approach this topic.

I begin with a proposition that is implied in Thomas Huertas' paper: Regardless of what one thinks about the merits of financial product deregulation—and despite his disclaimers, that is what we are talking about at this conference—continuing technological advances and market forces make the blending of financial service offerings inevitable. This has already been recognized in England, and most recently in Canada, which have permitted bank affiliations with other financial enterprises.

Here at home, even though Congress has been stalemated on the bank powers issue, the *states* have been taking matters into their own hands by gradually expanding the activity authority of the banks they charter (Saulsbury, 1987). Indeed, I forecast that once the states allow nationwide interstate banking—now probably less than five years away—they will turn with vigor to bank activity deregulation. The Federal Reserve may try to control this process through its jurisdiction over bank holding companies. But its legal authority to do so is unclear. Moreover, if holding companies begin to disband and place their nonbank activities as subsidiaries of their state-chartered banks, the Federal Reserve would be powerless to stop them. In short, just

as the states led the way toward interstate banking, they are likely to be the agents of change on the product-line front.

Neither Huertas nor James Tobin discuss this scenario, even though in my view it is the most likely way in which the debate over financial restructuring will be settled. However, Tobin's warnings about the risk-creating incentives of deposit insurance coincide with my own reservations about letting financial product deregulation proceed at the state level. My concerns center around the fact that state deregulation means that nonbank activities will be conducted *directly* out of the bank or through a bank subsidiary. In either case, as William Seidman noted yesterday, the nonbank activity appears directly on the asset side of the bank's balance sheet. To be sure, it may be less costly for banks to enter other activities directly rather than through holding company affiliates. But if the insurance, securities, or real estate operations fail, the capital of the bank will be *directly* impaired. And if the impairment is sufficiently serious, the Federal Deposit Insurance Corporation (FDIC) will then be called upon for a rescue. In short, the FDIC ends up insuring not only depositors but nonbank operations as well—a result I suggest that not many in this room would applaud.

It is noteworthy that the recent FDIC staff study has recognized this problem (FDIC, 1987). Its constructive solution is not to count as part of a bank's capital a bank's investments in nonbank subsidiaries. Nevertheless, I still worry about the ability of politicians or regulators to distinguish properly in advance between activities that belong directly in the bank and those that should be placed in bank subsidiaries. In addition, permitting banks (rather than their holding companies) to be the vehicles of product-line diversification blurs the division of responsibility among regulators. In effect, the federal bank supervisory agency—whether it is the FDIC, the Comptroller, or the Federal Reserve—must assume responsibility for supervising and regulating all of the activities conducted out of the bank or its subsidiaries.

For this and other reasons, most of those advocating financial restructuring have proposed that new nonbank activities not now operated by banks be conducted out of separate affiliates—belonging either to current bank holding companies with expanded powers or to new financial service holding companies. Huertas does an excellent job of summarizing these proposals in his paper.

Huertas' most useful contribution, however, is his lengthy discussion of steps that can increase the "R-factor" of the holding company arrangement, or insulation of the bank from its nonbank affiliates. This discussion is significant, because it is the most comprehensive attempt I have seen yet from a banker—and even from Huertas himself—to come to the grips with the insulation issue.

At bottom, Huertas has two central recommendations. First, in line with a now famous article written by Fischer Black, Merton Miller and Richard Posner (1978) nearly one decade ago, Huertas urges policymakers to look to bank capital for the necessary protection—that is, require banks belonging to highly diversified organizations to maintain an extra layer of capital and then force their divestiture from the rest of the enterprise if actual capital falls below a threshold minimum.

Second, Huertas argues that the Federal Reserve should get out of the business of regulating bank holding companies. Instead, he would pass the buck back to the Comptroller of the Currency to address the concerns that have prompted proposals to limit daylight overdrafts and to require banks to deal with their affiliates at "arms length". Significantly, Huertas would enhance the Comptroller's authority by giving him (or her) the ability to seek immediate court injunctions to stop unsafe or unsound bank practices (without going through the potentially lengthy hearings required in cease-and-desist proceedings).

In principle, this plan could work. But I find surprising, given what I know to be Huertas' firm faith in the market and his skepticism of government intervention, the faith he and apparently other market-oriented specialists in this field place in supervision and regulation to minimize the risks of bank activity diversification. I am not so confident. The bank divestiture or "bear down" requirement, for example, cannot be effectively implemented without much more frequent bank examinations than occur now. Otherwise, regulators will not be able to catch banks from coming to the rescue of their affiliates—until it is too late. As the former chairman of Citibank New York, Walter Wriston, stated in a now infamous remark in 1981, "It is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world" (Wriston, 1981). I would add that in the "real world" our regulators

failed to catch Continental Illinois, Penn Square, and Seafirst before each required rescue or depositor payoff.

In addition, Huertas does not tell us whether his additional capital requirements would be based on market value (rather than historical cost) accounting. But if market values are to be used, we are left to wonder how at least in the near term the nontradeable loan assets banks carry on their books are to be priced with sufficient accuracy to use market-based capital amounts as triggers for bank divestiture.

Yet, even if regulators had an accurate trigger, Seidman reminded yesterday of another important fact from the "real world". The day the FDIC steps into a bank, its resale value can fall by up to 25 percent. That should tell us that the FDIC can still remain very much at risk even with an "intelligent" bank closure policy.

Huertas' insulation devices also fail to address two other potential problems. One is the danger that bank depositors will run if nonbank affiliates are threatened. However irrational this behavior may look, it happened in 1973 when a mortgage banking affiliate of a bank in Beverly Hills, California failed. It can happen again, especially as we move to the "Brave New World" of full product deregulation.

Second, those who advocate a regulatory approach to increasing a bank's R-factor must recognize the danger that politicians will turn the "R" into an "X". Specifically, I suggest that if and when opponents of bank product deregulation recognize they are on the losing side of the debate, they will switch tactics by urging Congress to enact a "telephone book" of statutory rules and restrictions to wall the bank totally from its nonbank affiliates. The first entry in this telephone book, I predict, will be restrictions prohibiting a bank from cross-marketing its services with those of holding company affiliates. Indeed, provisions of this type were written into the 1987 banking legislation just signed by the President this month. As Huertas correctly notes, such restrictions eliminate the scope economies from jointly delivering multiple financial services and, thus, dramatically reduce incentives for banking organizations to diversify.

As some of you may know, I have advocated "narrow banking" as a way of avoiding the telephone book problem while addressing the major risks of permitting bank organizations to diversify freely (Litan, 1987). I do not claim credit for the idea. Others, including Carter Golembe, John Karaken, and Al Gilbert, have also written about the concept. Indeed, the origins of narrow banking go back

to the 100 percent reserve proposal discussed by Henry Simons and Irving Fisher.

Briefly, I have proposed the creation of a new *voluntary* option for organizations that want to own an insured depository and also to engage in an unrestricted set of nonbanking activities, financial or commercial, beyond those currently allowed for bank holding companies. In exchange for broader powers, these highly diversified organizations would have to confine the activities of the insured institution solely to accepting deposits and investing the proceeds in safe, liquid securities—Treasury securities or instruments guaranteed by the federal government or by a quasifederal agency, such as Ginnie Mae or Fannie Mae mortgage securities. Significantly, these "narrow banks" could not make loans. Instead, the diversified conglomerates would conduct any lending activities out of separate affiliates funded by uninsured liabilities or equity (much as General Electric Credit Corporation or Commercial Credit operate today). To made a transition possible, I would allow existing bank holding companies to exercise broader powers as long as they adhere to a ten-year schedule for steadily transferring loans out of their banks into the new lending entities.

Several other features of the plan are worth noting. Only the narrow banks, but not their affiliates or holding companies, would have access to the payments system. Furthermore, nonbank affiliates could not have deposit accounts with their related narrow banks, eliminating any threat to the payments system from nonbank activities. Finally, I would place no restrictions on cross-selling of services by banks and their affiliates or on operation with common names and employees out of common locations.

In shod, both the R-factor and telephone book problems can be solved simply by requiring highly diversified banking organizations to reverse the historical accident noted by Tobin by separating their deposit-taking and lending activities. If the nonbank operations of financial supermarkets failed, the insured bank would be protected, both because it would be fully securitized and, thus, could withstand a run and because it would not be able to prop up the affiliates by lending to them or their customers. In addition, there would be no need for a telephone book full of regulations aimed at potential conflicts, tie-ins, and other abuses, because the depository arm of these conglomerates simply would not be able to lend to customers of other

parts of the organization. Last, but not least, narrow banks are tailor-made for Edward Kane because they can be easily required to adhere to market-value accounting.

Tobin's proposal to reduce the risk of insured depositories is very much in the same spirit. But as he himself stresses, his proposals to create "deposited currency" and to redefine commercial banks have a different purpose: to correct abuses in deposit insurance rather than to permit banks broader product-line freedom in a risk-minimizing way.

To this degree, the Tobin proposal is even more radical than mine because it would require all banks—and not just those belonging to diversified supermarkets—to change their asset portfolios.

My agenda is different. Because I believe that financial product deregulation is inevitable, the sooner we structure the process in a socially optimal way the better off we will all be. I therefore support relatively severe restrictions on bank asset holdings as the necessary social price for allowing bank organizations to diversify freely.

My version of narrow banking differs from Tobin's in another significant respect. Tobin wants to prohibit or severely constraint *all* banks from assuming interest-rate risk—by restricting their assets to short-term loans and investments and to only those long-term assets with variable rates. However, it seems to me that the recent abuses of the deposit insurance system have not primarily involved excessive interest rate risk, but simply bad loans. That is the main reason I would structure the assets of narrow banks to eliminate credit risk by limiting them to holding federal securities. In addition, Tobin's definition of narrow banks would not solve potential conflicts problems in a deregulated environment because his banks would still be free to extend loans to customers of the nonbank affiliates.

Nevertheless, Tobin's narrow banks may have an advantage over mine if we move to broader product deregulation, an objective that I understand he does not endorse. Specifically, if, as I suggest, narrow banks in diversified organizations are to be prohibited from extending loans, then the loan-making function would increasingly be performed by uninsured institutions. As a number of people within the Federal Reserve System have argued, this could expose the uninsured lenders to the equivalent of deposit runs if they could not "roll over" their liabilities (Parry, 1987). I believe this risk is overestimated for three reasons. First, only the least risky banking organizations

would even be able to take advantage of the narrow bank option because only they would have loan portfolios of sufficiently high quality to be funded by commercial paper or other uninsured debt or equity. Second, precisely because their liabilities are uninsured, the lending affiliates of narrow banks would have higher capital ratios than conventional banks. Third, now that the commercial paper market, like the market for conventional debt and equity, is highly developed, I do not accept the argument that if one lending institution that relies on commercial paper for funding (such as General Electric Credit Corporation) fails the commercial paper market in general will collapse. Nevertheless, whether or not I am correct, it is worth noting that the application of Tobin's narrow bank model in a deregulated climate would pose less risk of a credit run because Tobin's banks would still be able to make loans.

In sum, both Huertas and Tobin have provided highly stimulating papers on an issue that needs some new thinking. I share Huertas' desire for further deregulation but lean in Tobin's direction (with suitable modifications) for policy solutions.

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