Overview

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Trying to do a wrap-up at this conference is not very easy. 'An awful lot has been said, and I agree with much of what has been said. But I want to make a few comments from my perspective.

Let me start with some rifle shots on individual points that I think are important in terms of trying to get the best possible perspective on the subject. These rifle shots come in no particular order but are my reaction to things that I've heard here.

Clearly there is a broad-based consensus that something has to be done about restructuring our financial system. There is even a broad-based consensus as to why it has to be done. I certainly would count myself among those who put considerable urgency behind the task of getting it done. I think Henry Kaufman touched on some of the reasons for that urgency, as have others. To put it into a nutshell, the need for action stems in part from the fact that a lot of what we are seeing in financial markets here and around the world is a product of the past five years of bull markets. One has to ask the question: How is it all going to look in the context of bear markets? Because certainly none of us, I suspect, would be so casual as to suggest that the business cycle and interest rate cycle are things of the past. That is my first rifle shot.

Secondly, there was some talk about goals—especially by Steve Roberts this morning—and I think that is very important. There is one goal that often goes unstated, so let me state it. That relates to what we call systemic risk and it is an overriding consideration. It involves trying to protect the system as a whole, as Henry Kaufman

puts it, against the possibility of a highly destabilizing "accident" that could undermine prospects not just in the banking or financial arena, but in the economic arena more generally. Such a possibility inevitably and automatically brings into play the so-called "moral hazard" problem. And the dimensions of that moral hazard problem I think do get more complex in a world today so characterized by speed and by the interdependencies of interconnections, domestically and internationally, that are now so commonplace. There is a natural tendency, as we have seen in these discussions, to think of that moral hazard problem as being exclusively or largely associated with so-called insured deposits. But the problem is broader than that, because there is at least a danger that the kind of systemic problem that could arise need not be one that in the first instance is uniquely associated with insured deposits.

The third rifle shot that we've got to keep in mind is that the public, and indeed the Congress, will demand financial stability. One of the interesting and very relevant points in Bill Seidman's paper I thought was about the swings in the pendulum in so far as attitudes toward regulation of the banking and financial system. Crises and disruptions do produce reactions and sometimes those reactions are not necessarily what we would like to see, but surely they are there. But the public certainly will demand stability, and in that sense we have to be at least mindful that we don't want reform for the wrong reasons. If we get reform for the wrong reasons, we can safely assume that it would be the wrong kind of reform.

In connection with this point about the public demanding stability, I'll share with you a recent anecdote of history that I think is relevant. For the first time, right now, we in the United States have embarked upon a program of formal regulation of the government securities market. And that formal regulation has, among other things, been supported by the market itself and by the Treasury Department. It's a rather astonishing thing, if you think about it. Because the government securities market, of course, was *the* market that was thought to be immune from the need for any kind of regulation. But what happened, of course, is over the period of several years a number of accidents took place on the fringes of the marketplace. These accidents by and large did not damage small unsophisticated investors, but hurt school districts, state and local governments and even, as I recall, a Congressional credit union. It is a simple but stark reminder

to all of us that the public will demand stability in the banking and financial arena.

Another point that is very, very important is the distinction that Steve Roberts made this morning. There is a lot of talk about the safety net and particularly on two important elements of the safety net: deposit insurance—whatever one may think of it—and the discount window. But there is some tendency to forget that the process of supervision and regulation itself constitutes the third leg of the safety net. It's not the payments system. Access to the payments system is part of the ***quid pro quo*** that goes with being subject to supervision. But I do not regard the payments system in and of itself—or access to it—as part of the safety net but a privilege extended to banks as part of their public role and as part of the ***quid pro quo*** for regulation.

One other quick observation is that in all our deliberations we have to keep in mind not only what is necessary or what is desirable, but also what is feasible.

In some ways the central question before this conference—around which there is probably a sharper difference of opinion than any other—is the question of whether there should be merging of banking and commerce. It should come as no surprise to anybody that I am rather strongly opposed to that and I don't think it has anything to do with being in the Federal Reserve. In my judgment it is the soundest approach to public policy over the long haul. I am not going to suggest that the answer I give is wholly without doubt. But we do have to pose this question in terms of the risks and rewards for taking a particular point of view in this area of public policy.

It is very important to keep in mind that one of the purposes of the Bank Holding Company Act is to permit a certain amount of interaction between banks and other affiliated companies. It is designed to permit that interaction, not to wall it all off, in a context in which adequate safeguards are taken, ultimately in the form of consolidated supervision. The bank holding company structure, with its separate affiliates and all the rest, makes a lot of sense for other reasons including facilitating the proverbial "level playing field" from a competitive point of view while facilitating functional regulation as well. Thus, based on the merits, I'm not ready to turn away from that structure. I would also suggest that if we're really serious about permitting a full blown merging of banking and commerce, that there is

only one relevant, somewhat contemporary, example that I know of to serve as a model. That is the so-called Zaibatsu banking commercial system in Japan. The history of the kinds of problems that evolved from those circumstances makes for very interesting reading, I can tell you.

As many of you know, I have spent a lot of time over a number of years thinking about the wisdom of maintaining the separation of banking from commerce. If anything, I believe I've moved further in the direction of 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 with a select group of institutions, 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.

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. Why, 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 explanation 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, (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 which 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 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 five percent of the stock in any one bank without even having to disclose such an investment.

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 than 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.

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 the 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 which 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 which 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 are either that the safety net surrounding banking will have to be extended—at least to an extent—to all who would own and control banks, ***or*** the safety net should be eliminated altogether.

I would conclude by saying that from my perspective, substantial and progressive reform is urgent and I would like to think it is within reach. And one of the reasons why I think it is within reach is that I believe we should be able to get there without having destructive battles. I would be remiss, too, it I neglected to note that the international elements of these issues, which I haven't touched on, are equally important and equally compelling as we try to deal with the many aspects of financial market restructuring.