

Overview

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I want to add my congratulations to the Federal Reserve Bank of Kansas City for the excellence for the program. There is no question that they have managed to assemble—at least until reaching this particular point in the program—a large percentage of the "best and the brightest" when it comes to financial system reform.

The role of an "overview panelist," I was told, can be whatever one makes it. I opted to offer reflections on several of the conference themes.

Our keynote speaker, Franklin Edwards, said near the end of his paper, and then repeated in his oral remarks, that the paper was ". . . a plea for action—an appeal to end the political paralysis that now immobilizes Congress and regulators." It strikes me that this serves well as the principal theme of the conference: a call for restructuring or reform with respect to the banking and depository system, the distribution of powers among financial institutions, the regulatory structure, and, worth noting separately, the system of deposit insurance. It is a theme that was treated with varying degrees of intensity or urgency—not all speakers found quite the same degree of urgency as did Edwards. But nonetheless, it was a theme that wound its way through all of the papers and all of the discussions.

Our first speaker mentioned, but quickly dismissed, the option of "muddling through." This morning, James **Tobin** used a less kind expression. If I caught his words correctly, it was "anarchic and disorderly drift." Still, it might have been interesting if someone had given the "case for muddling through" or at least had sketched

some of the possible consequences. I say this because, notwithstanding the unanimity at this conference that something should be done, there is a good chance that "muddle through" is what in fact may be in the cards.

If so, would the result be as Edwards predicts—an explosion or collapse of the system? Or would it be the picture, conjured up in my mind at least, from the Robert Eisenbeis paper—that of a huge wave of technological and financial change washing over the landscape, about to leave behind some rather limp irrelevancies once known as commercial banks and deposit insurance systems? Or would we in fact end up at about where we wanted to be all along, possibly led there by the states, as Robert Litan so cogently pointed out, although most likely at the cost of considerable delay and much additional expense? I just do not know.

There seemed to be little or no dispute over what is forcing change. My notes on the causes mentioned by various speakers overlap considerably. One thing that stands out is that technological change appears at the top of almost every list.

As to what needs to be done, in most instances there was substantial agreement, with only a few differences, largely of degree or over implementation. For example, broader powers for banks or bank holding companies passed, I sensed, by a rather comfortable majority. Of course, the receipt of additional powers was usually related to, or contingent upon, other reforms desired by the speaker. Securities powers headed the list when it came to additional banking powers.

As an aside, I should say that I was personally delighted to hear that the sacred line between banking and commerce is not quite so sacred in the view of a number of our speakers. However, it still seems live and well for a few others.

The urgent need for reform of the deposit insurance system also came through rather clearly, at least from those speakers—which means most—who addressed the subject. The most logical reform in my view, but the least practical politically, is fundamental reform, by which I mean returning deposit insurance to its origins—a limited purpose, social-welfare system designed to protect depositors of modest means against one of life's vicissitudes, a bank failure.

I should make a brief comment on the issue of whether a bank may be "too large to fail." The matter surfaced in floor discussion yesterday in a colloquy between Kenneth Guenther and William

Seidman; it was mentioned in Tobin's paper; and then it came up again today when Frank Morris introduced it. I agree with those speakers, such as Tobin, who argue that banks of any size should be allowed to fail. On the other hand, it is perfectly conceivable to me that the failure of any private institution, bank or nonbank, might have grave repercussions—so grave that the government might feel compelled to step in to protect the national interest. I doubt that Continental Illinois was such a case. But if it was, then it fell well outside of the deposit insurance system; it had no more relevance to deposit insurance than did Chrysler or Lockheed.

The Federal Deposit Insurance Corporation (FDIC) had an insurance commitment in Continental Illinois of about \$3.5 billion, an amount well within the capabilities of the deposit insurance fund. I would argue that the FDIC should have been prepared to meet that commitment, and nothing else. If Continental Illinois had to be saved for reasons of state, then the decision and implementation responsibilities were with the Treasury, the Federal Reserve, and, given sufficient time, Congress.

The matter of priorities was raised by several speakers, Seidman and Tobin in particular. Both suggested that one should put a proper structure in place before proceeding to make any changes in the authority or powers that could be exercised by banking organizations. This does make sense. But I have to report that I had dinner last Saturday evening with one of the top bank lobbyists in Washington, who described to me in some detail how he expected to ensure that the moratorium on bank powers was not extended next March and how banking might then succeed in obtaining additional powers. He was quite optimistic, although he conceded that one of the few clouds on the horizon was that the banking industry might get itself mired down in debating various structural reforms. Having just finished Tobin's paper, I asked did he not think that, logically, the structural reform issue should be settled before one thought about congressional action to restore or expand the powers of banking organizations. His reaction was one of shocked disbelief. It may be some time before I restore my credentials with that gentleman.

On the matter of various institutional structures, I have just a few comments. First, it is heartening to see the growing acceptance of the idea that insulation of banks in a holding company framework is possible—that regulators can confine their attention to **banking** and

not to related activities. As one who has argued this proposition for years, I know how lonely that position was, even four or five years ago. The regulatory agencies were virtually unanimous in dismissing insulation. We have come a long way when a chairman of the FDIC, at least one and possibly several governors of the Federal Reserve Board, and the Comptroller of the Currency agree that insulation is feasible.

Second, I have long favored Litan's "narrow-bank" approach to structural reform, although possibly I would be a bit less narrow than he in defining the assets that a bank with insured deposits must hold. I like his approach in considerable part because it accomplishes a basic deposit insurance reform, i.e., it makes deposit insurance largely unnecessary. But it could also solve many other problems, as Litan indicated in his remarks. Its flaw, possibly fatal if one takes a narrow Washington view, is its saleability, with the difficulty probably more pronounced in the banking industry than in Congress.

Accordingly, I favor the **financial** services holding company concept, which Thomas Huertas described so well, and in particular I think that the proposal made by the Association of Bank Holding Companies deserves support. That proposal, and others, in effect finesse the basic need for deposit insurance reforms by structural arrangements that insulate the bank and, therefore, limit the reach of deposit insurance and the government's exposure. Combined with continued experimentation in enhancing depositor discipline—say through the modified payoff proposal of the FDIC—the financial services holding company concept may be the most feasible, attainable approach.

I must confess, however, to a sneaking fondness for some elements of the Seidman approach, primarily for the reasons he gave Guenther in the luncheon discussion yesterday. If the Seidman approach can be pulled off, it is a far simpler, cleaner way of accomplishing some important objectives.

In this connection, I was fascinated by the political implications of the staff paper presented by Seidman yesterday. It is awesome in its audacity. Consider that the approach that he is urging is certain to irritate banking's competitors, and in particular the securities industry, when he proposes to repeal the Glass-Steagall Act. He cannot be making any friends at the Federal Reserve by proposing a repeal of the Bank Holding Company Act, in addition to dismissing a cherished belief of the Board of Governors that "the bank holding

company should be a source of strength to the individual banks." And then he is in effect telling two of the largest banker associations in the country—the Association of Bank Holding Companies and the American Bankers Association—that their financial services holding company concept, on which they have labored so long and about which a summit meeting is scheduled for September 9-10, is not really needed. I wonder where he will find allies to support his proposed restructuring.

The question that remains with me as we begin to close the circle here this morning is, again, one posed by our first speaker. If the need to restructure is so clear, why is something not being done? Franklin Edwards placed the blame on the persistence of some myths, which he claimed hobble us severely. Edward Kane took a different swing at it, to the effect, as I understood it, that if only the voters knew what was being done by the regulators and the legislature—the hidden subsidies and the like—then reform would be possible.

I cannot disagree with Kane of course, except to say that there are other problems. And I agree with Edwards that the myths he cited need demolishing. The problem is that some have already been demolished and we are still mired down. I think, therefore, it might be worth taking a few moments to look more carefully at this matter.

A most formidable obstacle to reform is Congress, and there are two important facts to keep in mind when it comes to Congress. First, Congress is insulated from market forces to a considerable degree. What Congress responds to is not the market but the pleadings of its various constituencies, and the result often depends on the relative political strengths of those constituencies. One would like to believe that the ultimate constituency—the people or the public interest—is that to which Congress responds, but that is not often the case when it comes to financial legislation.

You would have to believe in the tooth fairy to believe that commercial banking lost its Glass-Steagall battles with the securities industry because it lost on the merits. The myth that Edwards mentions—that the separation of bank and securities activities is necessary for financial stability—has been thoroughly demolished. It is hard to find anyone in the agencies or, for that matter, on Captitol Hill who believes it. What the banking industry has failed to do is what the securities industry does so well, namely, mobilize congressional support; and among other things this means mobilizing sufficient cash

and distributing it in the most productive manner.

It is easy to dismiss these grubby battles over turf as something that will go away if only we fix our sights high enough and deal with cosmic issues of reform. But you still have to get from "here" to "there." Any reorganization of banking powers involves a good many turfs, not just one. In these congressional wars, the more numerous and better financed battalions are not on the side of banking.

The second fact is that, generally Congress prefers to avoid doing anything when it comes to banking and the financial system. To be sure, there may be a few legislators who like to see financial issues stay alive and unresolved, thereby filling their campaign coffers, but most senators and representatives **find** that financial reform is essentially a "no win" issue when it comes to the folks back home. They prefer, therefore, if at all possible to delegate whatever power Congress should responsibly assume when it comes to financial reform. The delegation to the states of interstate banking authority is simply one illustration.

Can Congress ever be counted upon to act swiftly and responsibly? I suppose the answer must be yes, but I would say that the chances are far better whenever a crisis is looming—and even then it is not certain that Congress will move with great speed. Of all the papers I have heard here over the past several days, it is the Edwards paper that I would most like every congressman to have on his desk. And that is because his paper—although toned down to some extent in his oral presentation—paints a bleak picture of imminent disaster if reform is not accomplished rather quickly.

Another quite formidable roadblock to reform is the banking industry itself. I know that it is possible to paint, as Seidman's paper does for example, a rather gloomy picture of trends in bank profits, losses, declining market share, and the like, and to conclude that banks are as one in their desire to achieve reform. Perhaps so, but reform of the kind that we have been discussing here is, I am afraid, a rather low priority for many banking organizations, most probably for the majority.

We have a great many banks in this nation. If any one of you has been before a group of bankers recently—particularly community bankers or regional bankers—and discussed what globalization or securitization should mean to them, then you know, as I do, that your talk did not end with wild applause from the audience and demands

for immediate action. In fact, the nonbank bank issue—an issue that, in the larger scheme of things, I regard as an irrelevancy—can generate more emotion among bankers in ten minutes than reform of the Glass-Steagall can generate in ten months.

The plain fact is that many banks are doing reasonably well, and a very large proportion of bankers are in a business with which they feel quite comfortable. They are generally aware that things are changing and that the future may not be all that bright. But this does not mean they are anxious to tear up the paving blocks and mount the barricades on behalf of reform.

Finally, there is one other impediment to reform that I hesitate to mention, given the wonderful hospitality that has been shown us here. Yet I do believe that the combination of monetary and regulatory powers in the Federal Reserve has meant that the Federal Reserve has been a significant barrier to reform in the past, and likely will continue to be one.

Obviously, I mean this in an institutional sense. I am not implying any malevolence on the part of Federal Reserve officials, whether at the Board or at the banks. And I am certainly not implying any lack of professionalism, or integrity, or concern for the public welfare—on all of these the Federal Reserve deserves the highest marks. Rather, it is because the Federal Reserve is in two different businesses—and those businesses do not mix.

One business, as I said, is the formulation and conduct of monetary policy, to which is attached "bank of last resort" powers. The other is the supervision and regulation of the expansion of banking organizations. The first, I believe, is the more important. Certainly it is a responsibility that must be exercised with the maximum degree of independence within government. But it is precisely that independence that is most threatened when the Board is forced to **become** embroiled in the political infighting characteristic of financial regulation. Consequently, and quite properly I might add, supervision and regulation takes a back seat.

What do I mean by "back seat"? For one thing, I mean caution, delay, and deference to Congress, even when Congress has clearly delegated responsibility to the Board of Governors, as it did in the case of powers that may be exercised by bank holding companies. Again, I am not trying to be critical. I am sure I would do the same thing if I were on the Federal Reserve Board. That is, when it comes

to a question of roiling Congress up on regulatory issues, I would keep my head down and be certain to protect the far more important flank—maximum independence within government.

What we have had, therefore, is a classic "Catch 22" situation. Congress delegates to the Board; the Board defers to Congress.

Among historians, one of the more fascinating games, although perhaps not terribly productive, is the "what if?" game. Military historians in particular love to play it. In financial history we have our "what ifs?," many of which center on the Federal Reserve.

For example, "what if" the Federal Reserve Board some 15 years ago had not bowed to political realities in Congress and had held that the savings and loan business was not only closely related to **banking** but also was a "proper incident thereto"? Some interesting scenarios can be spun out from that one, given what has happened since. One, for which I could make a case, is that there would have been an orderly merger between the banking and thrift industries, that the present **thrift/FSLIC** problem would be much smaller, and in fact, that there might be no FSLIC today.

Another, even more intriguing "what if?" can be identified if we go back to 1969-70, when the **Nixon** administration, and most particularly the Treasury Department, labored valiantly to amend the Bank Holding Company Act to provide that its administration would be distributed among the three banking agencies. For example, bank holding companies with a preponderance of assets in national banks would be regulated by the Comptroller of the Currency, in state nonmember banks by the FDIC, and in state member banks by the Federal Reserve Board. That effort was beaten down in part because of the political astuteness of Chairman Arthur Burns, who managed to persuade Congress that the Federal Reserve really had no interest in regulating banks or much of anything else, but simply thought that it was the most experienced group when it came to determining the limits within which bank holding companies might expand. And so far as those limits were concerned, the chairman was prepared to suggest that the Board was thinking of being rather liberal, setting forth a menu that included, among other things, some interesting securities powers. That was 17 years ago.

But "what if" the **Nixon** administration had been successful? Even though the sought-after law required **agreement** of the three agencies, what might have happened if Section 4 of the Bank Holding

Company Act had been administered over the years by, say, a Jim Smith, a Tod Conover, or a Robert Clarke when it came to national bank holding companies, or by a William Isaac or a William Seidman when it came to nonmember bank holding companies? One can come up with a number of possibilities. My guess is that we would not be meeting here today, or at least we would not be meeting here on this particular issue.

In summary, the picture that I saw painted at this conference was one of rapid, almost bewildering, change in financial markets, pointing to a need for structural reform, the outlines for which are, generally, fairly well agreed upon. What gives me pause is: 1) that the ultimate rulemaker—Congress—is not very responsive, 2) that one of the major players—the banking industry—despite our holding out the glories of salvation does not exhibit any great desire to be saved, and 3) that one of the key regulatory agencies—the Federal Reserve—does not seem to recognize or agree with the proposition, implicit in so many of the structural reform proposals, that one of the essential elements for structural reform is its own demise as a regulatory agency.

Perhaps after all our future does indeed lie with the states. But given all of this, I regret even more that we never did hear the case for "muddling through."