Overview

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This symposium on "Restructuring the Financial System" is exceedingly timely. Extraordinary changes are taking place in the financial markets and Congress and regulators are slow in responding to these changes. Franklin Edwards was right, in his opening remarks, when he stated that "we must determine the financial system of the future, and put in place a compatible regulatory system." He then went on to say, we have "to agree on fundamental goals of financial regulation and on the amount of government intervention needed to achieve these goals."

I would express my concern more fervently. I feel very strongly that our financial system is going astray. Many deposit institutions are weak, and business and households have assumed massive debt burdens. This poses serious risks for our economy. In light of these risks, the current system of financial regulation is inadequate to deal with changes in financial markets. Congress should abandon the current system and pass comprehensive legislation to install a better one.

In designing a better regulatory environment, we must ask ourselves what kind of a financial system we really want. What should the financial institutions and markets try to achieve? How can this be accomplished effectively while safeguarding the public trust? Are there important distinguishing aspects between financial institutions and other private enterprises in the economy? In other words, we should begin setting forth a rationale for our financial system and then establish some of the tenets that will move us closer to an improved financial regulatory structure.

To begin, let me say that it would be impossible to run our complex and advanced economy effectively without integrated supportive activity from financial institutions and markets whose role is to intermediate the savings and investment process. Financial institutions and markets reconcile the needs of both the demanders and suppliers of funds. If we did not have an efficient financial system, the behavior of spending units and of savers would be severely limited and our economic performance would be sharply curtailed. Among other things, a well-functioning financial system should facilitate stable economic growth. In a broader sense, it should promote reasonable financial practices and curb excesses.

Some members of the financial and academic community make an important distinction among the underlying functions of the financial system. They divide the functions into two parts: to provide a mechanism through which flow all payments and to provide the framework through which allocating credit is efficient. This distinction is made because there is a clear need to safeguard the payments mechanism, but it is less clear that our system of credit allocation requires such safeguards. I believe, however, that in the financial world today, these functions are intertwined. The differences between money and credit are blurred. In an attitude that has changed markedly over the past few decades, borrowings are considered by many to be a source of liquidity and, therefore, a substitute for money or highly liquid assets. Short-term assets like Treasury bills and commercial paper are considered substitutes for money. Thus, the greater risks that may be inherent in today's credit structure are not reduced by paying special attention to safeguarding the payments mechanism, which once upon a time was a cash-only function. Moreover, other important financial changes have taken place that have affected the functioning of our financial system and that have often induced regulatory responses without full thought to the ultimate consequences. I will briefly mention five developments that need to be incorporated in plans to improve our financial system.

First, financial institutions today primarily acquire funds by bidding in the open market. This bidding for funds has been partly responsible for blurring the differences among financial institutions. A broad menu of obligations is available to temporary holders of funds and savers. Many are highly knowledgeable about these instruments and markets. Few institutions hold much in the way of "captive funds" at below market yields.

Second, institutions and other participants in the financial markets now actively engage in ‘‘spread banking^{w}—an effort through which institutions try to lock in a rate of return that exceeds the cost of their liabilities. This practice began years ago as a commercial banking technique, but other institutions and businesses have followed suit with the creation of many new credit instruments ranging from floating-rate obligations to interest-rate and currency swaps.

Third, these spread banking and related opportunities were greatly enhanced through "securitization"—which, as is well-known, is the process by which a nonmarketable asset is turned into a marketable instrument. Today, many credit instruments have been securitized, including consumer credit obligations, mortgages, high-yield corporate bonds, and many derivative instruments, such as options and futures. They have enhanced the growth of the open market and inhibited the growth of the traditional banking market. Yet, many of these instruments, new as they are, are not completely understood and have yet to be tested in both bull and bear markets.

Fourth, financial institutions and markets are much more international in their activities. Funds flow from one country to another electronically with extraordinary volume, sometimes moving counter to underlying trade developments. Facilitating these international flows, large U.S. commercial banks and investments banks have built up great operations in key foreign money centers, and concurrently, foreign financial institutions are enjoying an increased presence in the United States. Today, many U.S. borrowers participate in both U.S. and foreign financial markets, and U.S. institutional investors are becoming more familiar with international opportunities. Again, the opportunity for reward has carried risk. Our money center banks' experience in lending to developing countries is one example. Managing the risk of floating exchange rates in a world of 24-hour-a-day trading is another.

Fifth, vast improvements in computer and communications technology are rendering many traditional institutional arrangements obsolete. Technological breakthroughs have a significant impact on the location of physical facilities, the communications linkages with clients, and the magnitude and speed of market decision making.

These changes, to a large extent, reflect the deregulation of interest rates without putting into place concurrently new prudential safeguards. In view of these developments, a number of issues need to be raised and resolved. One is whether financial institutions should be subject to'special regulatory treatment. My answer is "yes." This is because financial institutions are entrusted with an extraordinary public responsibility. They have a fiduciary role as the holders of the public's temporary funds and savings. They generally have large liabilities (other people's money), a small capital base, and are involved in allocating the proceeds from these liabilities to numerous activities that are critical to the functioning of our economy.

If the role of the financial system carries a public or fiduciary responsibility, as I believe it does, then a governmental role in guiding the system is valid. No highly developed society has treated financial institutions and markets as strictly private activity, and Congress itself has long since recognized the role of central banking in guiding our financial system.

This distinction also hinges on the necessity for keeping the ownership of a financial enterprise separate from that of business and commercial activity. To combine the two would surely lead to economic and financial concentration, to major conflicts of interest, and to a compromise of the public responsibility of financial institutions. Equally important is that a marriage of business and the financial system would substantially widen the official financial safety net that is now extended only selectively to businesses and institutions when financial difficulties erupt. A mix of commerce and finance would spread the safety net to cover many private large enterprises. This, in turn, could lead to additional economic inefficiencies at the expense of small and medium-size enterprises that would suffer proportionately more in periods of economic distress. The result would be more economic and financial concentration.

Another question that needs to be addressed is whether financial institutions should experience the benefits and discomforts of monetary policy or should they be mere conduits that pass the full impact of policy on to households and businesses. In the past two decades, financial institutions have increasingly become conduits. Through spread banking and other techniques, for example, they have quickly passed on the higher cost of funds to local government, business, and household borrowers in order to protect their own profit margins. As a result, much higher interest rates have been required to achieve effective monetary restraint.

The final demanders of credit—such as consumers, businesses, and governments—have been encumbered with a higher interest cost structure. The ability of financial institutions to shift higher costs quickly has encouraged them to become more entrepreneurial and more aggressive as merchandisers of credit. Similarly, the securitization of credit obligations is probably loosening the traditional ties between creditor and debtor, adding to the entrepreneurial drive in the financial system.

The disquieting manifestations of this financial entrepreneurship abound today. Despite a sharp deterioration in the quality of credit reflected on the balance sheets of financial institutions, the drive to exploit growth through the continuing rapid creation of debt is very much alive. Banking institutions that are overloaded with the debt of financially weak developing countries are currently striving to extend credit to sectors in which debtors are still viable, such as households and businesses. The open credit market operates under the false assumption that marketability means high liquidity; it is exploiting the issuance of high-yield bonds and is taking on activities that are akin to bank lending practices. Financial market participants, however, will not escape from what has come about. The rapid growth of debt and its costs create a burden on households and businesses that is then, in turn, reflected back on the weaker and more marginal assets of our financial institutions; these institutions then become encumbered with inadequate capital and, consequently, experience pressures to improve profits by moving into other ventures. There is little solace when the deed has been done. By then, the financial system and its participants have been weakened.

In this context, the central bank operates precariously. It has to drive interest rates to hitherto unthinkably high levels when monetary policy restraint is required, because institutions have no vested interest in slowing credit availability early; it must also cut interest rates sharply once restraint is effective to avoid bankruptcies. The risk under this approach is that the central bank has to take on the role, increasingly, of lender of last resort to a wider range of financial and business participants. In essence, the recent changes in our financial system have facilitated the transfer of risk to the ultimate borrowers and investors. However, this has not eliminated risks from the system. Indeed, the process has contributed to a faster rate of debt creation, ultimately increasing the risks in the economy.

Financial institutions are not just the guardian of credit, but in a broader sense, they are also the mechanism that can either strengthen or weaken a market-based society. Financial institutions should be part of a process that encourages moderate growth of debt and substantial growth of equity and ownership. To be sure, to achieve such objectives, a correct fiscal and tax structure must be in place. Substantial risk taking and entrepreneurial zeal belongs properly in the world of commerce and trade, where large equity capital tends to reside, and not in financial institutions that are heavily endowed with other people's money. Encouraging increased leveraging of financial institutions automatically induces greater leverage in the private sector, making this area more vulnerable, more marginal and eventually inviting government intervention. The whole process thus undermines the essence of an economic democracy.

In this regard, there are a number of unalterable facts. First, when financial institutions act with excessive entrepreneurial zeal, the immediate outcome is a contribution to economic and financial exhilaration. Only later, when the loan cannot be repaid on time or the investment turns sour, are the debilitating and restrictive aspects of the excesses fully evident. In addition, official exhortations to limit the excesses of financial entrepreneurship are inadequate if not futile.

To some extent, our current regulations encourage risk-taking, because large institutions are not allowed to fail, and it is virtually impossible for major financial participants to remain uncompromised to some extent. As is clearly evident all about us today, the competitive pressure to be in the new mainstream of markets is intense. Growth aspirations are difficult to thwart once institutions set targets for profits, market penetration, and balance sheet size within a financial framework that prescribes no effective limits and that encourages, with great intensity, the application of financial ingenuity and liberal practices.

Thus, this issue comes down to'whether or not financial institutions should be a vehicle for sheltering households and businesses from becoming highly exposed financially. I believe that a bias in this more prudent direction would be quite desirable. In addition to the vulnerabilities that I have already mentioned, a less entrepreneurial financial system would reduce the wide gyrations in the financial markets, encourage longer-term investment decisions and focus society's efforts on meeting economic goals. As I will indicate later, this shift in financial direction is not yet beyond our reach.

Much of the debate on the reregulation versus the deregulation of financial institutions rests on just these issues. Do financial institutions serve an important public role, and in this role, should financial institutions protect households and businesses from financial excesses? The debate should not be decided solely on the basis of the so-called inequities in the marketplace today or on the premise that U.S. financial institutions should have sufficient flexibility to compete with rapidly growing financial institutions and markets in the United States and abroad. The resolution of the debate on these particular points will not necessarily strengthen our system. What others do may not be right. Indeed, if our banks had been inhibited in the past from competing so aggressively in the international arena, they would be stronger—not weaker—organizations.

However, if the Congress decides that a more deregulated financial system is preferred, at least two challenges will have to be met: How are institutions and markets to be disciplined? And, how will institutions have to be structured to compete on a level playing field? The disciplines of a deregulated financial system are simple in concept, but difficult—if not impossible—in reality, to accept, especially in a highly advanced economic society. Efficient institutions will amass profits and prosper, and inefficient ones will stumble and then fail.

The difficulty in accepting such disciplines reflects the fact that the failure of financial institutions involves other people's savings, along with temporary funds from the institutions in question and from other organizations linked to the financial institutions through the intermediation process. Moreover, such a deregulated system will surely burden households and businesses with an even greater overload of debt and make the economy more marginal. I hope that Congress will not move in this direction.

The obstacles to achieving a level playing field—a framework that would ensure competitive equality among the different types of institutions—are formidable. What kind of standards, if any, should institutions be required to adhere to? Can there be true competitive equality if the liabilities of some institutions are federally insured, while others are not? I doubt that deposit insurance can be eliminated from our financial system. If it were, market participants would assume that the official safety net would cover an even larger portfolio of the financial system until a major institution is allowed to fail, and then the risks of contraction in the financial system and economy would be extremely high. It is the type of risk that we, as a society, should avoid.

Now, much was said in the last two days of our discussions about the role of the commercial banks and the broader powers that should be accorded to them. However, in restructuring the financial system, we cannot overlook the many changes that have occurred in the open credit market, both here and abroad. Robert Eisenbeis spoke about the changes in clearing arrangements. On the whole, very little was said about the huge growth in open market transactions, in derivative credit instruments, about the credit exposures in the various clearing mechanisms, about the potential settlement problems, and the extraordinary capacity to speculate in this financial world as compared with the more limited aggressive financial activity a few decades ago.

In formulating the groundwork for an improved financial system, we cannot and should not return to the compartmentalized structure that prevailed years ago. Financial life is evolving, and we should be able to retain the best and discard undesirable aspects of this process of change. To ignore the developments in our financial world will invite the risk of substantial disarray. Those who favor further substantial deregulation do so on the grounds that such a system, by being highly competitive, will provide services at the lowest cost. They ignore both the special fiduciary role of institutions and the fact that the costs of service delivery are only one aspect in judging the performance of the financial system. They also fail to recognize the consequences of allowing failures to be the sole disciplining force in this system.

Advocates of substantial deregulation, however, do not agree when it comes to deposit insurance. Large institutions often favor the removal of insurance altogether or insurance fees associated with the risks involved in the insured institution. The assumption here is that large institutions will have an advantage, because even in a fully deregulated environment, the government would be much more hesitant to allow such institutions to fail. The likely consequence would be increased financial concentration. Deposit insurance based on the associated risks would probably also not work well, because higher fees would boost the costs of already marginal institutions, promote enlarged risk taking to offset these costs and put depositors clearly on notice that they are maintaining accounts with a vulnerable institution where deposit insurance may not hold.

Many advocates of regulation want to maintain the status quo. This position, I believe, is completely unrealistic. Adherents to this view fail to acknowledge some of the important changes that I mentioned earlier: the aggressive bidding for funds by institutions, the globalization and securitization of markets, and the quick pass-through of costs by institutions to final demanders of credit. Only a few have called for some sort of new regulation. For example, E. Gerald Corrigan, president of the Federal Reserve Bank of New York, has put forth a well-reasoned and articulate set of proposals for reforming the financial structure. On the whole, he emphasizes arranging the institutions in our system into three groups: bank and thrift holding companies; financial holding companies; and commercial and financial conglomerates. I believe that this arrangement is influenced by his central banking responsibility. He wants to ensure that the central bank, as the lender of last resort, can function effectively in crisis periods.

Corrigan's analysis stresses having a well-functioning payments system, and he has argued persuasively for keeping commerce apart from banking. But as I stated earlier, the blurring of the distinction between money and credit means that safeguarding the payments mechanism is only one part of an improved financial regulatory structure.

What then should be done to establish a reformed financial system that recognizes the changes that have occurred and concurrently provides the underpinnings to encourage stable economic growth and provide for the general wellbeing of an economic democracy? I suggest the following.

First, an official central authority should be established to oversee all major financial institutions and markets. Today, we live in a highly integrated financial system in which, as I noted earlier, institutions bid for funds and, in some instances, carry on comparable activities in the allocation of these funds. The current system of diverse and overlapping official supervision lacks a coherent overview and fails to meet the realities of the financial world today. This new central authority should also establish minimum capital requirements and uniform reporting standards, and it should require much greater disclosure of the profitability and balance sheet data of our institutions. When monetary restraint is required, this new centralized authority should increase the minimum capital of financial institutions. In this way, institutions would be restrained, and households and businesses would be less encumbered financially. The reverse would, of course, hold when monetary ease is needed. Capital requirements based on the riskiness of assets is a step in the right direction. This authority should also set a time schedule that would require all institutions to report their asset values at the lower of cost or market. Such a requirement would further inhibit the weakening of our financial institutions.

Second; an official international authority should be established to oversee major financial institutions and markets, regardless of their location. Its membership should consist of representatives from the major industrial nations. As noted earlier, global financial institutions and markets exist today—a fact that makes the supervision of institutions and markets by national authorities ineffective. Borrowers and institutions quickly arbitrage the regulatory capital requirements and other differences between one financial center and another. At times, the agility of market participants limits the policy effectiveness of central banks. Consider, for example, how easy it is for participants who have access to international financial markets to circumvent the policy objectives of central banks or how much more forcefully others have to be constrained in order for monetary policy restraint to achieve its objective in tightening markets. Such an official international authority should set minimum capital and reporting standards for all major institutions that operate internationally, and uniform trading practices and standards should be established for participants in open market activities.

Third, because conflicts of interest run the serious risk of undermining the efficient functioning of the financial system and the economy, they must be avoided. There are three activities that need to be kept apart: lending, underwriting of securities, and equity investing. Conflicts of interest are bound to arise if these activities are joined.

With these conflicts of interest in mind, the following principles should underlie new financial regulations.

First, commercial and financial institutions belong apart.

Second, financial institutions should not be allowed to be both lenders and equity investors. The system of regulation should force financial institutions in their dealings with the business sector to choose whether to be an underwriter, a lender, or an equity investor.

Finally, deposit insurance should be used to strengthen the financial system—and not serve only as a guarantee of the safety of deposits. The proceeds from all insured deposits should be required to be invested either in high-grade securities or loans that are deemed to be highly creditworthy by the official regulators. If deposit institutions prefer to make lower quality loans and investments, they should be booked in another institution and financed with noninsured funds.

There are no easy and quick solutions to the problems that now permeate our financial system. The comprehensive review that Congress is undertaking currently is a welcome prerequisite for formulating a new and improved structure. Your investigation should focus not on how quickly the last vestiges of the Glass-Steagall Act can be removed, but rather, the issue before Congress should be "If not Glass-Steagall, then what?" A fully deregulated financial system is not the solution. Financial institutions have a unique public responsibility. Consequently, a better regulated financial system that incorporates the many changes that have taken place in the past few decades is, in my opinion, the correct way. This will position financial institutions and markets to facilitate economic growth instead of contributing to substantial economic turbulence in the future.