For Release on Delivery
November 2, 1988
9:15A.M. E.S.T.

GOVERNING BANKING'S FUTURE: MARKETS VERSUS REGULATION

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CATO Conference on Banking Regulation
Washington, D. C.
November 2, 1988

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Lessons From History

No one who studies the history of American banking can fail to be struck by the ever-present tension between market forces and regulatory presence in the American banking system. In view of the vast changes now impacting our banking system, I believe that the topic of your conference is highly appropriate and timely.

In the early years of the Republic, the First and Second Bank of the United States provided an anchor to America's emerging banking system -- but much of the American populace saw these institutions not as an anchor that provided stability, but as an anchor that impeded progress.

Thus, it came as no great surprise that when the charter of the Second Bank of the United States expired in 1836, the nation let the market place determine the shape of banking, and a quarter-century of free-wheeling banking by state-chartered institutions ensued.

A measure of stability returned when Congress passed the National Banking Act of 1863, although it did so more with an eye toward the needs of Civil War finance than the need to reform the chaotic banking system. Nevertheless, the legislation provided for the establishment of the Office of the Comptroller of the Currency, who had the power to charter National Banks that would be subject to stringent capital requirements, and mandated that circulating bank notes be backed by U.S. government securities.

The Federal Reserve Act of 1913 provided again a central bank for the nation, and also defined the regulatory functions of the Fed. Subsequent legislation further expanded and elaborated on the role of the nation's central bank.

Markets and Regulation

But while I am a supporter of free markets, I am also a central banker. I also believe in the Constitutional mandate that Congress shall have the power to coin money and regulate the value thereof. Thus, monetary affairs are the proper realm of government and the institutions set up by Congress to execute these functions serve a legitimate purpose.

But it is also clear that rules and laws should have a certain flexibility so that the institutions do not impede the functioning of the markets, but support their development. Flexible rules allow the individual financial institutions the leeway they need to adopt to a changing environment so that the financial needs of individuals and corporations can be accommodated.

The rules and regulations also should be equitable, so that fair competition is fostered. This applies to domestic as well as foreign institutions that compete in the same market place -- an important point to which I would like to return later on.

You will address two important issues at this conference: they pertain to our ability to insulate banks from associated institutions in order to protect the federal safety net and questions regarding the international coordination of regulation. Let me address them in turn.

Insulating the Bank

Insulating a bank from the economic and financial fortunes of associated activities or companies is necessary because the federal safety net offers special protection for the depositors in financial institutions. The Federal Reserve's discount window is a ready source of liquidity for banks and helps them to avoid being caught short of cash to pay off depositors. FDIC insurance offers explicit protection to depositors and is largely responsible for the absence of runs on banks -- an event that otherwise might not be unheard of in these financially troubled times.

The insulating properties of firewalls between the bank and associated companies are not only needed to protect the safety of depositors, but also to avoid giving companies associated with banks access to low-cost funds that might otherwise give them a competitive advantage vis-a-vis competitors without such a privilege. Thus, insulation is a two-way barrier.

I believe that current laws, especially as embodied in Articles 23 A and B of the Bank Holding Company Act, provides the necessary insulation of the bank from its sister companies. But just to be on the safe side, and to further protect the banking system and the depositors, the Federal Reserve has long adhered to the policy that a holding company should serve as a source of strength to its subsidiary banks and stand ready to provide additional capital funds in times of financial stress.

Source of Strength Policy

The source of strength policy acts as a most important safeguard to the banking system. In its absence, holding companies might well be tempted to ask the bank to remit excessive dividends, charge unwarranted management fees, or otherwise loot the bank. As we have found out, especially in times of financial stress, there is literally no limit to the inventiveness of the human mind when it comes to devising new methods to get hold of money -- legal or illegal.

Furthermore, if a holding company would have the option of cutting subsidiary banks off if they failed to perform up to expectations, true chaos would descend upon our financial system. Under such circumstances, branch-banking institutions might be tempted to reorganize as a bank holding company with many subsidiaries. Then, as one or the other subsidiary would encounter difficulties, it would be allowed to fail and the FDIC would be left to pay off the depositors -- while the holding company shareholders would be left whole, and maybe even be in a position to walk away with handsome profits from the healthy subsidiaries. That would be the implication of corporate separateness carried to the extreme.

A Double Umbrella of Protection

Instead, I have advocated the "Double Umbrella" concept for bank holding company structure. Under this concept, banks could be owned by financial service holding companies -- along with securities firms, insurance companies, and other financial institutions. The financial service holding company would have to make a commitment to serve as a source of strength to the bank subsidiary in return for the privilege of being allowed to own the bank with access to the federal safety net and the payments system.

I would also permit commercial firms to own financial services holding companies, but again with the proviso that they have to serve as a source of strength to the financial services holding company. Thus, there would be a double umbrella of protection over the banking system -- something that may well be helpful in these troubled times.

Recently, the Federal Reserve Bank of St. Louis, published a staff study that evaluates a broad range of financial restructuring proposals with respect to the likely losses to be borne by the FDIC, the rate of return to shareholders obtained due to additional diversification, and other factors.* I was gratified to see that according to this evaluation the "Double Umbrella" concept results in the lowest cost to the FDIC (neglecting the complete merger case of banks and non-bank institutions) while allowing shareholders to achieve returns that are only insignificantly different from the returns obtainable under the other alternatives studied.

As long as we are on the topic of the optimal corporate structure, let me also mention the Federal Reserve's belief that any operating subsidiaries should be subsidiaries of the holding company and not of the bank itself. There are several major reasons for this belief one, if the subsidiary organization is a subsidiary of the holding company -- rather than the bank -- it is made abundantly clear that the federal safety net can not be used to support the subsidiary if it should run into difficulties itself.

Two, in those cases where the parent might want to come to the assistance of the sub, it would be clear that no funds obtained by the bank at preferential rates could be used to bail out the non-bank sub. This charge might well be made if the sub were a sub of a bank with access to federally insured deposit funds.

Three, if a subsidiary of a bank were to encounter difficulties, these problems would be reflected in the consolidated balance sheet of the bank. Hence, confidence in the bank itself might suffer and depositors might fear for the safety of their funds. This dilemma would not arise if the subsidiary were a sub of the holding company, as the bank's balance sheet would not reflect the problems of the associated institutions. For these reasons, the Federal Reserve believes that it is important that ancillary non-banking activities be carried on in subsidiaries of the holding company, rather than in subs of the bank.

International Regulatory Cooperation

Let me now turn to the international regulatory issues. It goes without saying that the ever increasing integration of our financial markets has clear implications for the coordination of international regulation. In years past, there was relatively little overlap between the various regulatory provinces, but with the ever increasing expansion of international banking, these issues have come to the forefront of the supervisory and regulatory agenda.

I will focus on two issues: the new international risk-based capital requirements and the policy of national treatment versus reciprocity, which has gotten much attention lately in the European context.

Risk-Based Capital

These days, no discussion of regulatory issues can begin without mentioning the new risk-based capital standards developed by the Basle Group of bank supervisors and endorsed in July by the central bank governors of the Group of Ten countries. While former international supervisory agreements typically relied upon reciprocal recognition of national supervisory standards, the Basle Group's risk-based capital framework represents the first truly global effort to regulate an industry.

The framework provides for the same definition of capital, the same risk classes, and the same leverage ratio for all internationally active banks.

The Basle agreement sets a 4 percent equity standard and an overall 8 percent minimum capital standard for the end of 1992. It also sets an interim target of 3.25 percent equity and 7.25 percent overall capital by the end of 1990.

In the meantime, the current 5.5 percent primary capital standard is still applicable. However, when considering capital adequacy of a banking organization, the Board may also consider whether the organization already meets the new risk-based standard. This ratio may be particularly important in the case of foreign bank applications that do not formally meet the current U.S. primary capital standard. As a matter of fact, the Board has already approved several foreign applications, where the applicant already meets the new risk-based capital standards.

The proposed risk-based capital standard has been out for public comment, and final rules should be issued in the near future.

Reciprocity Versus National Treatment

I mentioned earlier the increasing importance of international financial markets. In 1992, the European Community will pass a milestone with the planned full economic and financial integration of the member countries. The shaping of EC policy for 1992 toward banks from outside countries is of critical importance to the United States banks.

There have been indications recently that the EC might impose a policy of reciprocity on banks from outside countries. Specifically, banks from those countries would not be granted the powers that are available to EC banks unless those same powers were permitted by the foreign bank's home country for banks from all EC member countries. As an extreme example of how this policy might be applied, a U.S. bank could be denied the right to branch throughout the EC since no banks, domestic or foreign, are allowed to branch throughout the U.S. Also, the securities activities of the U.S. banks in Europe could be restricted because of the restrictions on banks' securities underwriting activities in the U.S.

Clearly, a policy of reciprocity would be detrimental not only in that it would harm the ability of U.S. banks to compete in the European market for financial services, but it could lead to further protectionist pressures that would be harmful to all. I strongly hope that the EC will apply the international standard of national treatment, rather than establish a new policy of reciprocity.

Needed Domestic Reforms

I also believe that we in the United States need to move rapidly to remove the restrictions that hamper the ability of U.S. banks to compete with foreign financial firms that operate much more freely.

Greater geographic diversification should enhance the safety of the banking system. This point is illustrated forcefully by the problems encountered by insufficiently diversified banks in the agricultural and energy producing regions of our country. This is in contrast to the situation prevailing in other countries where nationwide banking has increased the safety and soundness of the financial structure through diversification.

While the states have taken the lead in this area, interstate banking is clearly an area where a national policy is called for. Let's apply the interstate commerce clause, which has brought us prosperity and a competitive marketplace, to banking as well.

With respect to expanded powers, unfortunately, Congress failed to enact appropriate legislation and the Federal Reserve will therefore be faced with applications by banks requesting new powers within the context of the existing legislation.

Conclusion

As you can see, life will continue to be interesting for all of us. The financial environment we will face in the future is not likely to be much less volatile than in the past. Further international integration and structural change will occur, and I trust that the innovators will be busy as well. That's the way it should be.

We as regulators and you as participants in the market place should therefore continue to enhance our capacity to cope with these developments. The creative forces in the markets need to be fostered and we at the Fed remain dedicated to providing a fair regulatory framework so that the private sector can continue to prosper and flourish.

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* R. Alton Gilbert, "A Comparison of Proposals to Restructure the U.S. Financial System", Federal Reserve Bank of St. Louis, REVIEW July/August 1988