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Altering Incentives in an Evolving Depository System:
Safe Banking for the 1990s

remarks by

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This is the twenty-fifth anniversary of the Chicago Fed's Structure Conference. One would have thought that after twenty-five meetings there would be nothing left to say about bank structure and competition. However, banking and financial markets have done more than is needed to keep this conference alive. Owing in large part to the information revolution, banking and financial markets today are vastly different from those of even ten years ago, not to mention twenty-five years past. It is clear that traditional banking markets are migrating. Not so many years ago, what a bank did was well defined -- banks lent money to firms and individuals and offered safe, insured transactions accounts. But now, more than ever before, banks must compete for their customers. Borrowers can go to any of a rapidly increasing number of consumer and business direct lenders -- including those not otherwise financial in nature. Corporate borrowers can also bypass banks by raising funds directly from the money markets. Depositors can invest in money market funds offering liquid, safe transactions balances. And, the creativity of investment bankers and the globalization of financial markets have opened up a seemingly endless range of instruments and markets for both borrowers and lenders.

Bankers, as one might expect, have not taken these changes lying down. They have attempted to -- and will continue to attempt to -- follow their customers into new markets. They have adapted to the market migration by changing the nature of the products they offer. Like chameleons, banks adapted to their new environment in order to compete with their rivals. As an example, consider the response of some banks to losing their best customers to the commercial paper market. These banks now issue large loans, which they in turn syndicate. This essentially duplicates the role of investment bankers in the commercial paper market. In other areas too, banks have responded to changes in their environment through the use of new techniques: an increase in private placement activity in the United States; the development of investment banking expertise abroad; the provision of investment advice and management; participation in interest rate swaps; the imposition of fees for services that used to be a part of the traditional banking package; the guaranteeing of credit market instruments for a fee; and credits that are part loan and part securities such as NIFS.

Of course, because of the regulations designed to protect the federal safety net, other tools that bankers would like to use are not available. The goals of the safety net, that is, deposit insurance and the discount window, are to give the public a safe place for its money and to protect financial transactions. Once a safety net is in place the public interest must be protected. The recognition that excessive risk-taking threatens the safety net and that access to the safety net can give banks a competitive advantage over non-bank rivals led to the enactment over time of regulatory restrictions on bank activities, including prohibitions on some powers that banks now desire to meet changed circumstances.

The Federal Reserve Board recognizes the importance of attaining relief from regulations adopted in an environment drastically different from that of today. Indeed, in many areas the Board has been and remains in the forefront of those seeking to change the regulatory environment. My experience suggests, however, that change, improperly managed, leads to risks as well as to new opportunities. One need only refer to the changes that have taken place in the thrift industry. The S&Ls reacted to their changed environment in ways that imposed great costs on themselves and society.

Prudent regulation must, it seems to me, balance the opportunities open to banks with a regulatory structure that provides the proper incentives to control risk. A key element here must be the foresight to permit enough flexibility for financial institutions to change with their customers. Flexibility is especially important because it is difficult to anticipate how and when future innovations will affect banking markets. The rapid pace of technological change reduces the time banks, and regulators, have to react. Flexible policies allow banks to respond to market forces, not to a regulatory schedule. The benefits of flexibility must be weighed against the potential that a new instrument will increase the riskiness of a banking organization. An overriding consideration for a bank regulator must be to minimize any threats to the safety net, the payments mechanism, and the financial system. We can minimize these risks while permitting flexibility by controlling the incentives banks have to exploit the deposit insurance fund and their access to the discount window.

With the proper protection in place, I believe that we can proceed confidently with our plans to allow banking organizations to offer a wider array of financial services. I suggest that there are four basic measures that should be taken to avoid potential abuses of the safety net.

First, risk-based pricing is a way of bringing market-like incentives to bear on bank credit and investment decisions. The prime example of a recent effort along these lines is, of course, the risk-based capital policy. This policy takes an important first step towards both a more efficient and a fairer distribution of capital requirements across the banking system. Bank and thrift capital levels are the most important defense against excessive risk-taking. By requiring banks and thrifts to hold more capital when they undertake riskier activities, the risk-based capital standards encourage banks to manage their risk prudently. However, the current risk-based capital policy does not allow the identification of risk differences as accurately as we would desire. As a further safeguard, we could institute risk-based deposit insurance premiums. Using risk to set deposit insurance rates has been suggested by many different observers virtually since the introduction of federal deposit insurance. Setting premiums on the basis of risk assessments could serve as a supplementary method to mitigate remaining incentives to undertake excessive risk inherent in deposit insurance. For example, the current risk-based capital policy treats a loan to IBM the same as a loan to a real estate developer. Assuming that these loans differ substantially in risk, they lead to a bias that could be removed by basing deposit insurance premiums on loan quality measures.

If we are to allow banking organizations to enter new lines of business, then we must not think of the risk to the safety net as coming solely from banking operations. A second measure of protection is necessary to insulate the safety net from the risks taken by the non-bank affiliates of a banking organization. This second measure would also help ensure competitive equity between banks and their non-bank competitors such as investment banks. Investment banks may be at a disadvantage relative to commercial banks in securities activities if banks can finance through the safety net. For these reasons, we must be careful that expanded bank holding company powers do not result in the extension of the safety net beyond banking. As you know, the Board believes that the holding company structure, with appropriate firewalls, provides the best way to achieve a clear separation of banking from non-banking activities. The holding company structure is predicated on the legal doctrine of corporate separateness. The firewalls will lead to some sacrifice of synergies, but we believe the insulation provided by the firewalls is an important way of protecting the safety net from claims against the non-banking subsidiaries of banking organizations.

I believe that firewalls will work to protect the bank and the federal safety net, although I would be among the first to acknowledge that some observers think that the firewalls will burn through just when they are needed most. While this debate goes on, I want to emphasize that banks and their non-bank affiliates should be treated as separate entities regardless of the particular structure employed for this purpose. It is my view that the holding company structure is the most efficient way of separating banking and non-banking lines of business.

Risk-based pricing and firewalls cannot be expected to eliminate the chance that some banks will get into trouble. Indeed, it seems that we must naturally accept some failures as the price we pay for a competitive and innovative banking system. As long as we set up effective mechanisms for either guiding weak banks rapidly back toward adequate capitalization or promptly closing institutions that cannot recover, the impact on the federal safety net will be small. The recognition that we will always have problem banks leads me to the third set of regulatory precautions I wish to discuss.

If banks fall below capital standards, they must understand that increasingly strict regulatory sanctions will be imposed. We must act well before a bank becomes insolvent. The problem of moral hazard increases as capital falls because banks have less of their own money backing each loan or investment. Delaying regulatory action only increases the eventual cost of acting. Any restrictions or sanctions imposed should be targeted to bring bank capital up to adequate levels expeditiously and to prevent the safety net from being further exposed. The actions could include such measures as restrictions on growth, on expansion of markets, and on the authority for banks to exercise certain powers directly or through their affiliates, if necessary forcing a bank and its affiliates to contract to their core business. One may debate whether such sanctions are likely to enhance opportunities for profitability by forcing a bank to concentrate on its core customers, or restrict profit opportunities by preventing the organization from expanding into new markets. Nevertheless, our primary goal for troubled banks should be to minimize any potential risk to the safety and soundness of the financial system. While this is generally best accomplished by returning a bank to profitability, we need to err on the side of caution with institutions that are already undercapitalized. Allowing a bank, or a thrift for that matter, to "grow out" of a problem, as some have proposed, may instead permit the problem to grow into something much bigger.

As a final step, if the measures I have just mentioned are unsuccessful, the assets of a bank holding company should be used as a source of strength for the troubled bank. It should be required of a bank holding company that it give a legally binding commitment to serve as a source of strength to its banks even at the expense of holding company creditors and non-bank businesses. The holding company should have to do whatever it takes to keep its banks adequately capitalized. A bank or its holding company could, of course, always avoid any sanctions by raising capital voluntarily.

To some extent, the steps I have just described are already followed by bank supervisors. For example, problem banks are monitored much more closely than healthy, well capitalized institutions and growth may be restricted in particularly risky portions of an undercapitalized organization. But, I believe that as we allow banks and bank holding companies to expand the range of activities they engage in, to prevent problem banks from becoming threats to the safety net and the financial system, it is necessary to give examiners stronger tools such as the ones I have just mentioned.

Taking strong action against problem banks sends a signal to healthy banks about the additional regulatory burden they will incur if their capitalization becomes inadequate.

Knowing that regulators will be knocking on the door deters bankers -- and their shareholders -- from taking excessive risks at a time when their banks are still healthy.

The final measure of protection is a necessary part of the previous suggestions: frequent, timely bank examinations. In the vast majority of cases, examinations show banks to be acting prudently. However, identifying problem banks early will permit the immediate remedial responses I have outlined already.

The objective of the precautions I have suggested is to set up a regulatory structure in which bankers have the freedom to participate in a broad variety of financial markets. Indeed, the Board's position on issues such as the repeal of Glass-Steagall has been made clear on a number of occasions. However, we all know there are still many unresolved issues. Now, I would like to turn to an important area where the path to be followed is not so clear.

One of the big changes wrought by the revolution in financial markets is the increasing globalization of financial and commercial activities. Many domestic banks are finding that an increasing share of their business is affected by international events. More and more, banks are operating directly in foreign markets.

In general, U.S. policy towards foreign direct investment has been based on the principle of national treatment. The International Banking Act established the applicability of this policy to foreign banks operating in the United States. National treatment means that foreign enterprises operating in a host country are given the same opportunities for establishment and operation as -- and are subject to the same regulations as -- domestically owned institutions.

As I have already explained, regulation of banking institutions in the United States relies to a substantial degree on the holding company framework to control risk. However, foreign banks are generally not organized into holding companies in the U.S. sense. This leads to difficulties in interpreting the principle of national treatment. For example, a Section 20 securities affiliate of a U.S. bank is required to be in a separately capitalized holding company subsidiary with no funding from the bank. These subsidiaries must raise funds on their own or borrow from the holding company and its non-bank affiliates. Currently, our interpretation of national treatment for the purposes of the Bank Holding Company Act treats a foreign bank with U.S. banking subsidiaries as a holding company. An ad hoc extension of this treatment to Section 20 applications could lead us to allow a foreign bank to have a Section 20 securities affiliate that is a subsidiary of the foreign bank. While this interpretation would not allow a U.S. branch of the foreign bank to fund the securities affiliate, the securities affiliate could still be funded from its foreign parent bank. I believe that this interpretation would treat foreign banks fundamentally differently from U.S. banks by allowing funding to flow from a bank to a Section 20 affiliate only for foreign banks. Conversely, if we were to treat the foreign parent bank like a U.S. bank, it could not fund its affiliate, and we would risk tilting the playing field in the opposite direction. Yet, this method might be preferable in that it would allow a foreign bank to set up a separately capitalized holding company structure for their operations in the U.S., with all its firewalls.

In foreign markets, the shoe is on the other foot. Typically, relative to the United States, foreign countries allow their banks a wider array of powers and require less separation between banking and affiliated lines of business. This clearly raises difficult issues. For example, if European banks can underwrite and deal in equity securities, do we want the European operations of U.S. banking organizations to be able to operate under the same rules outside the United States in order to compete with their local rivals? Following a policy of "when in Rome, do as the Romans do" -- which would mean allowing securities activities abroad to be conducted in a bank or a bank subsidiary -- may jeopardize our progress in insulating domestic banks -- and the safety net -- from the risk of non-bank activities. But, walling off an equity securities subsidiary using the bank holding company structure could weaken the competitive standing of the U.S. organizations abroad.

A further complication is that U.S. banks have a long history of conducting foreign activities under the rules of foreign markets with prudential limitations. The Edge Act of 1919 as amended in 1978 is specifically designed to encourage U.S. exports and to allow U.S. banks to compete more effectively against foreign financial institutions. The Edge Act allows banks to set up special subsidiaries for international operations, called Edge corporations. A foreign subsidiary of an Edge corporation is allowed to conduct some non-bank activities, such as underwriting corporate debt and, to a limited extent equity, in foreign markets, that would not be permitted for bank subsidiaries in the U.S. In my view, the existing framework should be maintained in order to allow securities activities to be conducted as the regulations currently permit. However, if we chose this approach, any expansion of equity underwriting and dealing above the present dollar limits might be required to take place in a holding company subsidiary.

Having listed just some of the problems, it is clear that resolution of these issues involves difficult tradeoffs, and it is not possible to find a solution that makes everyone happy. We may have to use a "second-best" solution and allow some inconsistencies between the way domestic and foreign operations are regulated. In this case, consistency may give way to competitive pressures with the understanding that protection of the safety net is still the priority.

We must bear in mind that setting up a framework for global competition will require coordination and cooperation with our colleagues at foreign central banks and governments. The risk-based capital agreement was, as I suggested earlier, an important move in this direction. However, the process must continue, especially since the European Community, as a part of its program to complete its internal market by the end of 1992, will be implementing major changes in the regulatory framework for financial services within the Community. Under the latest proposal from the EC for the treatment of third country banks, as I read it, the

EC would not restrict access for our banks to European markets, essentially on the condition that we maintain our policy of national treatment. I would prefer that the EC implement a policy of pure national treatment, as we do, that would permit U.S. banks to operate in European markets without imposing conditions on access for European banks to U.S. markets. What is important in any case is that both sides should view any outcome as ensuring a fair and open market on both sides of the Atlantic. I welcome the competition provided by European banks in this country. We are willing to be flexible in working out differences between the regulation of financial institutions in the United States and the European Community. As I noted earlier, any outcome should preserve the safety and soundness of our financial system while offering all banking organizations a level playing field.

The final resolution to many of the issues I have raised remains unclear; however, any resolution of the problems caused by the increasing internationalization of financial markets should be, I emphasize again, flexible and forward-looking. We know that further changes in financial markets are inevitable. We must allow bankers the flexibility to follow their customers into new markets while at the same time preserving the safety and soundness of the financial system. By altering the incentives in the manner that I have described, we can allow bankers to respond to the evolving financial system while helping to ensure safe banking in the 1990s.