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RULES, RISK, AND REFORM:
A PROPOSAL FOR THE NEXT DECADE

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I would like to begin by thanking Bob Forrestal for giving me the opportunity to address this timely and important conference. We are indeed entering into a new decade for the banking industry, hopefully one in which we will be ready to undertake much needed reforms and restructuring of the banking industry and its regulation. Lawmakers, regulators, the banking industry, and the general public have all recognized the need for legislation to restructure our financial services industry.

Rather than reviewing other proposals for reform, I would like to outline the key ingredients of banking industry reform as I see them. While some of my views are shared by my fellow Board members, some are distinctly my own.

The need for reform stems from a number of concerns. Two pressing concerns are the large number of failed and marginally healthy banks in recent years, and the consequent strain on the bank insurance fund, which now requires recapitalization. The causes of these difficulties are complex, and include an expansionary monetary policy in the 1970s followed by the necessary correction, and increased competition due to deregulation and technological change. Also, the moral hazard inherent in the deposit insurance system contributed significantly to these

problems, as banks with diminished levels of capital faced increasingly adverse incentives. Since the bank insurance fund is ultimately backed by the full faith and credit of the United States Government, these adverse incentives must be addressed by public policy. This should be the last time that banks or taxpayers have to pay for deposit insurance fund shortfalls.

Additionally, competition and efficiency in banking have been impeded by laws more appropriate for another era. The McFadden Act inhibits the market system by limiting interstate banking and branching, resulting in higher operating costs and decreased diversification. The Glass-Steagall Act places many restrictions on the combination of commercial and investment banking -- a distinction that is increasingly outmoded. This separation reduces the realization of economies of scope and hinders banks' ability to face increasing competition from nonbanks in traditional banking areas. Removal of these restrictions would result in more efficient, competitive, and healthy banking and financial services industries.

The outline for reform that I shall suggest today is shaped by the principle of fairness and has the overriding goal of promoting the well-being of the public and of the nation's economy. To this end, I will specify three more specific objectives.

First, we must protect the banking and payments systems from systemic risk. Banking system instability could seriously jeopardize the performance of the real economy. The only realistic means I see of achieving this objective is the maintenance of a system of federal deposit insurance and regulation of banks.

Second, we should take steps to reduce the moral hazard inherent in deposit insurance. To do this, we must reduce the perverse subsidy to bank risk-taking provided by the current system of deposit insurance. Facing more accurately priced risk, banks would take less risk, thus reducing bank failures. This would, in turn, reduce the economic inefficiencies that result from bad loans and bank failures, decrease expected deposit insurance fund losses, and lead to lower deposit insurance premia. To this end, I suggest a more significant role for equity capital, including a system of prompt corrective action for banks that fall below increased minimum capital standards. These measures would increase market and regulatory discipline on banks, encouraging them to curtail excessive risk-taking.

Third, we should promote an efficient and competitive banking industry. This objective is both an end in itself -- for it helps foster an efficient and competitive economy -- and a means of reducing future deposit insurance fund losses. To meet this objective, we should permit increased geographic and product-line

diversification for banking organizations. In doing so, however, we must not extend the safety net beyond the bank. Any such extension would increase the economic inefficiencies that result from mispriced risk and would likely lead to greater deposit insurance fund losses. Moreover, I believe we must retain the separation of banking and commerce, since this separation is integral to an efficient and competitive economy.

Application of the principle of fairness to bank regulation mandates that we ensure:

- that, regardless of their size, banks in similar circumstances receive similar treatment,
- that banks know as clearly as possible the rules to which they are subject, and
- that banks and nonbank providers of financial services compete on a level playing field.

As I have said, the need to protect the banking and payments systems from systemic risk requires the maintenance of a system of federal deposit insurance and with it, federal bank regulation. Spill-over of banking panics into the real economy could serve to worsen economic downturns, as undoubtedly occurred during the Great Depression. Moreover, only the federal government is sufficiently large to ensure depositor confidence when it is most needed.

I believe that part of a fair and efficient deposit insurance system is for all bank deposits to be insured. I support this proposal for two reasons. First, it promotes fairness. Currently, all depositors at banks that are "too large to fail" are de facto insured. Under this proposal, depositors of small and large banks would be treated alike if their banks fail. As a consequence, small banks would no longer face the funding disadvantage that stems from differential regulatory treatment relative to large banks. Moreover, despite its many benefits, interstate branching would permit too much unfair competition if some banks retained a funding advantage from being "too large to fail."

Second, the task of monitoring the financial health of a bank would fall to more sophisticated players -- the bank's owners and their creditors -- instead of depositors. Let me illustrate how I feel with an analogy. I would not want the transportation department, instead of hiring engineers to conduct inspections, to put up signs at every bridge saying, "cross at your own risk." Similarly, I am uncomfortable with the idea of asking bank depositors to "bank at their own risk."

Increased minimum capital requirements are essential for more efficient bank regulation and a more healthy banking industry. Higher capital requirements would increase market discipline on banks by increasing the

incentive to preserve the owners' stake. This would make banks more accurately assess the costs of risk-taking, thereby reducing bank risk-taking and the chance of bank failures and increasing the efficiency of the deposit insurance system. Furthermore, increased capital requirements also reduce the need to rely on more bureaucratic means of reducing moral hazard.

Capital is a bank's (and therefore the insurance fund's) best defense against bad times. It is my belief that currently bank capital is generally too low to ensure proper owner incentives. If banks had held greater capital at the beginning of the 1980s, there would have been fewer bank failures over the past decade. Not only would higher capital have given banks a greater buffer against losses, but by putting more of bank owners' money at stake, higher capital would have increased banks' sensitivity to the risks they took.

While picking an exact number is difficult, I am thinking of minimum bank capital on the order of ten percent tier one capital to risk-weighted assets. If ten percent seems surprisingly high, recall that prior to the institution of federal deposit insurance, bank capital ratios were normally above twenty percent. Moreover, median capital ratios in financial services industries that do not have deposit insurance are today significantly higher than ten percent. Clearly, any move to increase bank capital

requirements would need a long transition period, to minimize the problems banks might face raising capital.

Because some banks may find a niche that exposes them to greater risks, we should adjust the risk-based capital system to account more fully for risk, including interest-rate and credit-concentration risk. The inclusion of these additional factors will more accurately price bank risk and will increase banks' incentives to control it.

At the same time that we increase and revise capital requirements for banks, I believe it would be highly desirable to eliminate capital requirements for bank holding companies. This would help limit safety net protection to banks, and free bank holding companies to seek a market-determined optimum capital-asset ratio. Moreover, it is appropriate that the market test would fall on more sophisticated bank holding company shareholders and creditors, not on less sophisticated bank depositors. Not only is it more equitable, but it is also more efficient to have market discipline imposed by investors rather than depositors. Compared to depositors, investors are less likely to respond to unsubstantiated rumors, so that the chance of unnecessary instability would be reduced.

Another part of my plan to make banks more sensitive to risk-taking is a very simple program of automatic prompt corrective action for banks that fall below

the minimum required capital. What I have in mind here is a set of clear and mandatory measures that would be imposed by regulators if a bank's capital ratio fell below the required minimum of ten percent. A bank holding company would not be allowed to extract returns, directly or indirectly, from the ownership of a bank that has capital below the minimum capital requirements. In particular, banks should be prohibited from paying a dividend or upstreaming funds in any manner, if such payment would reduce the bank's capital ratio below my proposed ten percent minimum.

In order to protect property rights and ensure fairness, I believe it is very important that all measures for prompt corrective action be mandatory and clearly spelled out in the law or regulations. Furthermore, such measures should be imposed equally on banks with equal capital ratios. Bank owners must know that if their bank's capital ratio reaches X, regulators will do Y.

If a bank's capital ratio were significantly under ten percent, there should perhaps be other mandatory restrictions on the actions of the bank and its holding company. Restrictions we should consider include restrictions on: the growth of bank assets and liabilities, the interest paid on bank liabilities, and expansion or acquisitions by the bank or its holding company.

In addition, when bank capital reaches some very low level, such as two percent, regulators should be

empowered to close or take control of the bank, subject to two conditions. First, bank owners' right to due process must be preserved by requiring a court hearing before regulators could close or take over a bank with positive capital. Note that in my plan, we would not have to worry that such a hearing would provoke a run on the bank, since all bank deposits would be insured. Second, any positive value the regulators obtain from either the sale or liquidation of the bank must be given to the bank's former owners. Again, it is important that this rule be precisely specified and fairly applied.

I also favor enhanced opportunities for bank holding companies whose subsidiary banks all have at least the minimum required capital ratio. This would give bank holding companies an additional incentive to maintain adequate capital at their subsidiary banks. Benefits could include streamlined regulatory procedures for expansion of the bank or its holding company, such as:

- opening de novo bank branches;
- undertaking new activities;
- bank mergers or acquisitions of banks by the holding company; and
- acquisitions of nonbanks by the bank or the holding company.

At this point, I would like to suggest consideration of an alternative to the menu of prompt corrective actions I have just discussed. In lieu of these many regulatory actions for undercapitalized banks, I believe we should consider the following two measures: First, allow no dividend payments by undercapitalized banks, and second, cap interest rates on brokered deposits at the interest rate paid on U.S. Treasury securities. The restriction of dividend payments would give bank owners strong incentives to maintain required capital ratios, while the floating interest rate ceiling on brokered deposits would reduce banks' ability to act on moral hazard, should they face it.

Admittedly, I am always uneasy with any departure from the market system, particularly one that might impinge on the efficient allocation of credit. Nevertheless, a floating interest rate ceiling on brokered deposits deserves consideration for several reasons. First, it would reduce the ability of troubled banks to finance growth outside their home market and thus to spread their problems to other banks. Experience over the past several years has shown that some troubled thrifts and banks have segmented their market by paying low rates in their home market and have bid up the rate on brokered funds, which has driven up the cost of funds and reduced the profits of their competitors. Second, I believe the effect on the allocation of credit

would be minimal, since in a growing area, funds could be raised at the holding company level or through individually held deposits. Finally, it appeals to my sense of fairness. Why should the U.S. Treasury guarantee national brokered liabilities with yields higher than its own?

Perhaps the best way to protect taxpayers from the need to finance the bank insurance fund is to pursue my third objective, that of increased efficiency and competitiveness of the banking system. This objective has the added and important benefit of promoting an efficient and competitive economy. To achieve this objective, we must remove federally legislated barriers to competition and scope economies in the banking and financial services industries. We should allow banks to expand their geographic scope and bank holding companies to expand the scope of their activities into related financial activities.

To foster the geographic diversification of banks, I would like to amend the McFadden Act to remove its constraints on interstate branching. The current prohibition on interstate branch banking by national and state member banks does not in any way serve to limit the extension of the federal safety net, yet it discourages geographic diversification and forces banking organizations to use what may be an inefficient structure for interstate banking. Since there is no off-setting public gain, why use

federal law to make bank holding companies conduct interstate banking in a multi-bank holding company framework, when it may be inefficient to do so?

It is important to note, however, that I only support nationwide branch banking if, as I recommended earlier, all bank deposits are insured. Otherwise, large banks would have a competitive advantage over small banks, for no other reason than the funding advantage they receive by being "too large to fail."

Before I discuss expanded activities for banking organizations, I want to emphasize up front that I believe the separation between banking and commerce should be maintained. Removing the separation of banking and commerce would compromise the impartial allocation of credit, with deleterious effects on the efficiency and competitiveness of our economy. Banks should base their lending decisions on a project's mix of risk and return, not on ownership ties that give the bank a vested interest in either promoting or hindering the success of a firm. Ownership ties might encourage banks to allocate funds less efficiently, by favoring funding of a commercial affiliate. Banks might also be tempted to withhold funding from the competitors of their affiliates, which would be both inefficient and anti-competitive. Furthermore, the separation of banking and commerce helps to prevent the undue concentration of resources.

I would like to allow bank holding companies of well capitalized banks to engage in additional financial activities via separately capitalized nonbank subsidiaries. The combination of banking with other financial services industries has potential conflicts of interest similar to those associated with the combination of banking and commerce. However, it is less likely to adversely affect the allocation of credit, because the ties between banks and nonfinancial firms would be less direct. Moreover, there are gains to be had from economies of scope, increased competition, and greater diversification at the holding company level. Let me stress, however, that expanded activities for banking organizations must not precede the institution of higher minimum capital requirements and a mandatory program of prompt corrective action for banks. We do not want to repeat the mistakes made in the early 1980s, when seriously undercapitalized savings and loans were granted additional powers.

Investment banking is an example of the type of activity I would like to permit for bank affiliates. Investment and commercial banking are so closely related that technological change and financial innovation have for some time been blurring the distinctions between the two. This suggests that bank holding companies already have much of the expertise they will need to be able to compete effectively in many underwriting and dealing markets. It

also suggests that there are likely to be economies of scope between commercial and investment banking. Insurance is another financial activity we should consider granting to bank holding companies.

We must be sure that expanding bank holding company activities does not mean expanding safety net coverage. Improved regulation of insured depositories, including increased minimum capital requirements and prompt corrective action, should help to ensure this. We should also maintain the current limits placed on transactions between a bank and its nonbank affiliates by Sections 23A and B of the Federal Reserve Act. In addition, I would like to restrict certain types of cross-marketing -- there should be no bank-premises marketing of obligations of nonbank affiliates -- and to require full disclosure by nonbank affiliates that they have neither direct nor indirect access to the federal safety net.

I want to conclude by saying that I am optimistic about the future of the American banking system. It has played and will continue to play a vital role in the smooth functioning of our economy. However, the system needs substantial reforms, sooner rather than later. We need to give financial institutions greater scope for regional and product-line diversification, and we need to impose greater regulatory and market discipline upon banks, through a

program of increased capital requirements and prompt corrective action.