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Statement of

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Task Force on Regulatory Reform

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Mr. Chairman, it is my pleasure to appear before the Task Force to discuss some critical issues in the area of financial services deregulation. Today there is a great need for reform of our banking laws. In my short time before you, I cannot address all of the issues that need to be resolved. I will therefore concentrate my attention on two key concerns -- one of which is immediate and the other more long-term.

First, with the moratorium on bank powers due to expire in a few days, the Congress must address the current separation of commercial and investment banking.

Second, our banking system is highly fragmented along geographic lines. It is time to create a banking system that can serve the financial needs of our citizens and corporations on a nationwide and, indeed, a global basis.

Repeal Glass-Steagall

Congress has considered for a long time a reform of the product range that banks are allowed to offer. Last year, a moratorium was imposed to "stop the clock" on bank innovation and regulatory action. That moratorium is set to expire in less than two weeks. Congress has pledged not to extend the moratorium. Thus, the time to act is now.

Repeal of the Glass-Steagall separation of commercial and investment banking would have many public benefits, which I shall outline in a moment. However, the immediate need to remove the legal barriers separating commercial and investment banking stems from technological changes over the past few decades. Advances in computer and communication technology have permanently altered the competitive environment of banks and other financial intermediaries. These changes have made it possible for non-bank institutions to offer a wide range of services that were previously the exclusive domain of banks. Banks, in turn, have attempted to expand their service lines, and they have pursued this goal aggressively. Now is the time for the Congress to legislate a restructuring of the financial system, before a haphazard _de facto_ restructuring occurs.

Let me explain what I mean specifically. A primary function of a bank as a financial intermediary is to collect and evaluate information pertinent to credit decisions. The more costly it is to gather information, the more valuable are the services of a bank which specializes in this task. Technological changes have improved the ability of firms and individuals to collect, store, and process information. As a consequence, the relative advantage banks have in evaluating the risks of lending has declined, and direct involvement in the credit markets by ultimate borrowers and lenders has increased.

Banks have responded to these developments by offering competitive products to the extent allowed by current law. For example, the development of the commercial paper market made substantial inroads into the traditional provision of working capital by banks. Banks then attempted to recapture at least some of the lost business opportunities by offering loan guarantees to commercial paper issuers.

Banks have also undertaken private placement of corporate debt and commercial paper, loan sales and participations, and interest rate and currency swaps. Through their foreign subsidiaries and affiliates, banks participate in a wide range of investment banking activities, including underwriting and dealing in corporate debt and equity.

In short, virtually all of the activities that banks would like to engage in on a full-scale basis are already permissible abroad or in private placement markets. Now is the time to level the playing field by removing the artificial obstacles that fragment our domestic markets.

Last week a federal appeals court ruled in favor of the Board's interpretation of the Glass-Steagall Act's "principally engaged" clause. This ruling lets stand the Federal Reserve's decisions to allow banking organizations to engage in limited securities activities in a bank holding company subsidiary. While we are very pleased with this decision, it underscores the need for a more comprehensive approach to expanded bank powers -- a step that only the Congress can take.

Repeal of the Glass-Steagall Act would have many benefits. Lower financing costs would benefit firms and state and local governments that need to raise capital. Consumers would benefit from a wider array of services being offered by a broader spectrum of financial firms. The safety and soundness of banking would improve as a result of the freer flow of capital into banking.

Bank holding company entry into investment banking would work to lower financing costs through increased competition in investment banking. Some investment banking activities are conducted in very concentrated markets. The entry of bank affiliates into these markets would lower underwriting spreads and thus lower the cost of raising funds.

For example, the Report of the House Committee on Government Operations presented evidence that corporate securities underwriting is highly concentrated. The five largest commercial paper underwriters account for over 90 percent of the market; the five largest underwriters of all domestic corporate debt account for 70 percent of the market; and the five largest underwriters of public stock issues account for almost half of the market.

Lower financing costs may also stem from cost efficiencies in the coordinated provision of commercial and investment banking services.

Both investors and borrowers are likely to benefit from greater access to the securities markets in a world without Glass-Steagall. Regional as well as smaller banks could offer depositors a wider range of products, such as mutual funds. A securities affiliate of a regional bank could underwrite debt and equity of local and regional firms as well as revenue bonds of local governments. This would provide local and regional firms and governments with the kind of access to the capital markets that is today mostly enjoyed only by large corporations.

From the point of view of bank safety and soundness, I look forward to another benefit of expanded bank powers: the free flow of capital into banking. If bank holding companies expand into the securities markets, they should become more attractive investments. This should make it easier for bank holding companies to raise capital.

Major concerns with expanded bank powers are the possibilities of increased bank risk and extension of the federal safety net to an even wider array of economic activities. I sha e these concerns. The federal safety net of deposit insurance and the discount window should not -- and I cannot over-emphasize this point -- be extended to cover non-banking activities.

The Board of Governors believes that the repeal of Glass-Steagall can be structured so as to neither jeopardize the safety and soundness of banks nor extend the federal safety net. This is because we believe that the risks of securities activities can be managed prudently, and because organizational forms can be constructed which control the degree of risk to the bank.

Banks have prudently managed the securities activities they are allowed to undertake. None of the domestic bank failures in the 1980s has, to our knowledge, been attributed to underwriting losses. In fact, we are unaware of <u>any</u> significant losses to banks in recent years from underwriting eligible domestic securities, such as federal government obligations, general obligations of state and local governments, and municipal revenue bonds issued to finance housing, university buildings and dormitories.

In foreign securities markets, where the limitations of Glass-Steagall do not apply, the performance of U.S. banking organizations has also generally been favorable. To the extent that there have been problems in overseas markets, they appear to have been in the nature of "start up" difficulties, not long-term problems. In the mid 1970s, some U.S. banking subsidiaries operating in London had problems with venture capital investments and the development of the Eurobond market. After deregulation of the London securities markets, several securities firms, including affiliates and subsidiaries of U.S. banks, experienced some transitional difficulties.

Evidence that we have seen since the October stock market crash has reinforced the conclusion that while securities activities are not free of risk, the risks can be managed prudently. In addition, securities activities should be monitored and supervised in such a way that risk to the bank is controlled. In particular, adequate capital should be maintained to absorb unexpected losses. Finally, an institutional and legal structure should be in place that minimizes the degree to which securities risk could be passed to a bank.

What type of institutional structure can best minimize the possible effects of the risks of new activities and limit the extension of the federal safety net? We recommend that expanded bank powers should be conducted in a subsidiary of a bank holding company and that the Congress place limits on transactions between a bank and its securities affiliate. These institutional "firewalls" would help insulate a depository institution from the risks of its securities affiliate.

The bank holding company framework is desirable for a number of reasons.

First, the legal concept of corporate separateness is strongest under a holding company framework. Corporate separateness provides that a separately incorporated company cannot normally be held liable for the actions of its affiliates or subsidiaries. This doctrine is more vulnerable to exceptions in the case of subsidiaries rather than affiliates.

Second, any losses incurred by a securities firm that was a subsidiary of a bank would appear as losses on the balance sheet of the bank. Therefore, losses of a securities firm could directly affect the market's evaluation of the financial health of the bank. This would not be the case if a holding company owned the securities firm.

Third, a bank may attempt to financially aid an ailing subsidiary because public perceptions about the health of a bank are so closely tied to the performance of its subsidiaries. This temptation is easier to resist in the case of an affiliate.

Finally, the holding company framework helps promote competitive equity. If the public believed that a subsidiary of a bank had some of the benefits of the federal safety net, then that enterprise might be able to raise funds at lower cost than a firm with no ties to a bank. Because of the legal separations between a bank and an affiliate, the public is less likely to perceive that the affiliate enjoys the benefits of the federal safety net.

In addition to putting securities affiliates in a bank holding company framework, the Board recommends that several other steps be taken in order to achieve the goals I have already stated. First, we recommend a prohibition on lending from a bank to its securities affiliate. This would reinforce the firewalls established by the bank holding company framework. We are concerned that even within the context of a bank holding company, a bank may feel pressure to lend to its securities affiliate. Any regulations allowing lending between a bank and its affiliate, however limited, might be subject to liberal interpretation in times of duress. Furthermore, such a prohibition strengthens the concept of corporate separateness.

Similar arguments apply to the prohibition of a bank purchasing assets from its securities affiliate, and we recommend this restriction as well.

Conflicts of interest pose another potential problem that might result from expanded bank powers. We believe that a slight strengthening of existing regulations concerning full disclosure in securities transactions, together with the firewalls I have just discussed, are sufficient to limit potential conflicts of interest.

In sum, we believe that the bank holding company framework can effectively insulate both the bank and the federal safety net from the risks of securities activities.

Permit Interstate Banking

In the immediate future, the Congress may be kept quite busy considering changes in bank securities powers. However, as soon as time permits, I urge you to take up the matter of interstate banking.

Removal of interstate banking restrictions would benefit banks, their customers, and the federal safety net. Interstate banking would make it easier for banks to diversify their loan portfolio and their deposit base. Geographically diversified banks would be less likely to fail as a result of regional economic difficulties. Bank customers would benefit from having a more diverse selection of banks to choose from. The general public would benefit from a more safe and sound banking system and less strain on the federal deposit insurance funds.

Diversification of risk can reduce the chances that a bank might fail. Clearly, one way a bank can diversify its loan portfolio is to hold loans from different regions of the country. An economic downturn in the oil patch or the farm belt will have less of an effect on the financial health of a bank that also has loans in New England than on a bank that does not.

This point is illustrated by the Canadian experience. Just like the United States, Canada experienced severe agricultural and energy problems. However, there was no similar rash of bank failures in Canada. It stands to reason that Canada's good record stems at least in part from the greater geographic diversification of risk that is achieved due to nationwide banking.

Most states have recognized the benefits of interstate banking and have passed legislation permitting at least some form of interstate banking. Forty states and the District of Columbia now have laws permitting entry by out-of-state, full-service banks. Currently, most of these states restrict entry to banks from a small list of states, usually in their own geographic region. However, twenty-five states have laws that will allow current or future entry by banks from any state.

While this is also very encouraging, there is room for more progress. The state laws are by no means uniform, and many states inhibit free competition by limiting entry to banks from a specified list of states. As a result, the American banking system threatens to remain fragmented and Balkanized.

Current federal law prohibits interstate banking unless it is specifically allowed by the state. This legislation is an increasingly archaic impediment to geographic risk diversification and should be removed. At some point, we will need new federal legislation to unify the maze of state laws and to extend interstate banking to all states.

Interstate banking would also provide bank customers with access to a greater variety of bank services. For example, manufacturers located outside of the major money centers have little access to institutions skilled in export financing. Consequently, our exporters are handicapped. Interstate branch banking would allow banks with this kind of expertise to set up branches wherever they might be useful, and customers would have access to banks that could serve them both at home and abroad.

For all these reasons, there is a need for a national policy towards interstate banking.

We all recognize the tremendous benefit that the interstate commerce clause has brought to the nation by creating a unified free market for goods. Let us extend the same benefit of a national market to banking!

Conclusion

In conclusion, I want to compliment and commend this Task Force for its efforts to come to grips with the complex and vital issues in financial services reform. Surely, the Congress and the people of this nation face many challenges in this area. However, the potential rewards to rational and timely action by the Congress are great -- the beneficiaries will include borrowers, depositors, banks, and the general public.