"Banking Reform This Year? A Scenario"

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It is a great pleasure for me to be with you tonight to discuss the regulatory outlook for financial services legislation this year and to discuss some of the many and varied questions which will arise over the course of the upcoming debate. The time may be ripe for long overdue fundamental reform in this Congress, and the issues on the table are remarkably broad and dynamic.

It may be useful at the outset to identify three separate categories of legislative topics. The first category, reducing regulatory burden, has the most immediate prospect of passage and would have the most immediate impact on the industry. It is in fact a continuation of the process begun in 1992 as the Congress began to unwind the red tape in which it had wrapped the industry at the turn of the decade. Some of the topics under consideration are: Streamlining Truth in Lending and Truth in Savings, simplifying the applications process, reducing the burden of the Home Mortgage Disclosure Act, the Bank Secrecy Act, and various management and micro-management mandates. A package of such changes appears to be almost certain to pass this year. And so, with a bit of trepidation, I will consider these to be

a "done deal" and not discuss them further in the balance of this talk.

The second category of proposals consists of efforts to reform both the regulatory process and structure, and several proposals are in play here, as well. Most immediate is a bill now moving through Congress which would declare a temporary moratorium on further regulation. This bill largely excludes banking, as it exempts monetary policy and safety and soundness initiatives but would, if enacted in its present form, stop any revision of the CRA process. Other pending legislation would reform the way agencies implement the law with a goal of lowering the costs of regulation. House Banking Chairman Leach has filed a bill which would, among other things, consolidate the Office of Thrift Supervision and the Office of the Comptroller of the Currency. Together with Congressman Wyden, Mr. Leach also proposes to consolidate the Commodities Future Trading Commission and the Securities and Exchange Commission. I have no doubt that other proposals in this area will be put on the table.

Finally, there is the most fundamental proposal of all, the legal reorganization of the depository institution industry which could, at the end of the day, involve virtually all financial services and regulators. Last year saw an important step in this direction with the passage of interstate banking and branching. Now the Congress seems poised to address the repeal of Glass/Steagall, with several quite different forms being proposed to take its place. Chairman Leach would allow banks and securities firms to affiliate in a holding company structure. Senate Banking Chairman D'Amato, joined by Republican House Banking Committee member Richard Baker, would permit the affiliation of banks with any type of commercial enterprise. The Treasury has proposed yet a third approach which would permit banks to affiliate with all types of financial services firms, either in a holding company or with the bank as the top tier corporation with financial subsidiaries beneath it.

All of this could hardly be more complex, as all of these ideas -- reducing burden, reforming regulation, and reorganizing financial services -- are being considered simultaneously and each

is interactive with all the rest. It reminds one of the frustrating puzzle called the Rubik's Cube where the object is to have all of the different pieces in proper alignment but whenever you move one the others fall into disarray. For example, consider the issues which would be raised if the Treasury's industry restructuring bill were to pass tomorrow morning. How should we structure regulators most efficiently? Functional regulation? Unitary regulation? With one super-agency or several? What role should exist for state banking regulators? State insurance regulators? How could we avoid overburdening these structures with too much duplicate regulation? What new legal doctrines of corporate separation and limitation of liability would be required?

Or, alternatively, what if tomorrow morning we passed a law realigning the regulatory agencies? How appropriate would this newly minted structure prove to be when, at a later date, we restructured the financial services industry itself?

It is clearly critical that Congress, and in its wake the regulators, keep everything in mind as each separate subject is approached. Either each part will work well or none of it will

work well. In this spirit it might be useful to attempt to articulate some guiding principles which could aid us in threading through this much needed rebuilding process. I suggest five, and here they are.

First of all, we should settle the structure of the financial services industry and then proceed to design the regulatory apparatus. Just as in designing an automobile, it would make no sense to design a brake system until one knew the size and shape of the car itself. Second, we should take time to pin down what we want regulation to accomplish. This is more subtle than it might look at first glance and is extremely important. Third, we must take care in the design of a new risk control architecture. Here, as in any structure, an imbalance could lead to collapse. Next, we must take care to design an appropriate regulatory process. Process can either enhance or inhibit the success of a new regime. And, finally, to ensure a continuing stable financial system there must be an appropriate central bank presence. Let's look briefly at each of these in turn.

First, industry structure. What are the alternatives and issues? Let me pass, very quickly, by the alternative of banking combining with commerce by saying that I believe this has a low probability of passage and, if it were to pass, it would raise a vast array of issues that are beyond the scope of these remarks. With that disposed of, the first decision then should be to decide between two basic types of financial industry structure. The first alternative is the financial services holding company which would separate banks from other financial affiliates by firewalls. Second, the universal bank would commingle all financial products either in, or under, a bank as the master legal entity. The Treasury's proposal would appear to allow both of the above to coexist and would seem to me to raise a number of practical difficulties. After the structure question is settled, and closely related, would follow the choice of what financial industry segments should be brought under the same tent. Starting with banking, should we add ... securities underwriting? debt and equity? All phases of mutual funds? insurance brokerage? insurance underwriting? life only? fire and casualty? Etc., etc.

Once we have a firm grip on these basic elements it is logical to proceed to the selection of an appropriate regulatory regime. The two ends of the spectrum of possibilities are to go with functional specialists, or at the other extreme, to utilize one super-regulator which oversees everything. Obviously, many types of hybrids and variations exist along that spectrum and every alternative has its own set of challenges and issues. A critical input in selecting a regulatory regime is a clear understanding of the second principle, which can be stated in the form of a question.

Exactly what do we want regulation to accomplish? Most of us could agree that our first objective is to protect the public. With a close second objective being to facilitate the continuing development of a low cost, convenient and broadly accessible financial services industry. In short, a balance between safety and soundness on the one hand, and efficiency and effectiveness on the other. Do we wish to do everything possible to prevent any failures or, more simply, to reduce their likelihood? There is a serious difference there. To what extent do we want to include

other mandates such as anti-trust objectives, full disclosure concepts and credit accessibility requirements? The point here is that in order to design a regulatory regime that will do what we want it to do, we must first know what that is.

Once we are clear on these things, we are ready to move on to principle three. We need to take care in designing a new risk control architecture. Two sets of concerns come to mind in this area. First, an appropriate balance of risks and rewards. And, second, an appropriate safety net.

There is great potential in a risk control structure to create an imbalance between risk and reward that could adversely impact the balance between safety and soundness, and efficiency and effectiveness. To create a regulatory regime that is too permissive invites excessive risk taking but on the other hand an overly harsh, hairtriggered, regime could create undue timidity on the part of management and thereby impede progress toward higher levels of efficiency and effectiveness. If we move toward a new structure in the near future, this whole area must be

revisited yet again. When the time comes to consider it, balance will be the key.

Now let's focus briefly on the characteristics of a safety net. Do we want one at all? Some say "no," but I assume that the ultimate answer will continue to be "yes." But, how extensive should it be? What and who do we want to protect? If it is to be the protection of basic household savings and liquidity, perhaps we have already gone too far because a person can easily shelter well over the nominal limit of $100,000 and the more extensive the coverage, the more extensive the required regulatory safe guards. That is because the government lacks the flexibility available to the private market place, and must stand behind all insured deposits without any control over their placement. Its only protection is regulation.

Moving on to principle four, we also must take care in the designing of the regulatory process which we select. Today the industry is struggling to emerge from an era of excessive and inflexible regulation. That's what reducing burden is all about. Disclosures. Audits. Applications. Records for everything.

Standards for everything. Overlapping examinations. Unclear CRA mandates. Etc. Etc. Let me add that among others who have been overburdened are the regulatory agencies! We must take great care not to repeat the over-do, un-do cycle of recent history. Here again balance is the key as we strive for an appropriate blend of broad legislative guidance and intent, regulatory flexibility, and private sector empowerment.

I would add one final precept; systemic stability necessitates a central bank presence. Broadly, the public interest requires (1) a strong supervisory process, especially where systemic risk is potentially present; (2) careful rule making; (3) a strong payment system; (4) available emergency liquidity; (5) effective monetary policy; and, (6) strong involvement with the financial authorities of other nations. Where can all these elements come together and mutually support each other? The central bank. Don't leave reform legislation without it!

In conclusion, what can I say about the regulatory outlook? Many positive signs indicate that events are on the move this year. The leadership of both Houses, both banking committees, and

both political parties have stated that reform is appropriate and timely in this Congress. The banking industry is healthy and there is no crisis atmosphere to muddy the waters. The securities industry now favors reform. And all the players are acting and working as if they expect something to happen, and soon. Obviously, many high hurdles must be surmounted. Every single element in this mix will be controversial and will require choices and compromises. There will always be some who will feel that no change is preferable to whatever change is on the docket at any given moment, and in Congress it is much easier to stop legislation than to pass it.

My best guesses are as follows. At this time broad regulatory burden relief, as mentioned earlier, is a virtual certainty. Some regulatory process reform, such as more stringent cost/benefit analysis and more public input into the regulatory process, is very likely. The defining time for basic restructuring will probably come in the second half of 1995. As of now, the horse is still ahead of the cart and industry structure will apparently be addressed before regulatory structure. While

the chances look quite good for positive fundamental change, it is always particularly difficult to achieve passage of such sweeping measures. However, if industry restructure can be accomplished, regulatory restructure will surely follow in its wake.

Will all of this follow the principles and sequences outlined in these remarks? Not perfectly, of course, but the closer the better.