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Remarks by

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Restructuring America's Financial Services Industry

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RESTRUCTURING AMERICA'S FINANCIAL SERVICES INDUSTRY

It is a pleasure to join you today to discuss the restructuring of America's financial services industry. The Boston University School of Law is to be congratulated for the timeliness of this conference as well as the impressive program. All of the speakers are playing a significant part in the statutory and regulatory reforms now in process to modernize the U.S. banking industry.

It has often been noted that lawmakers frequently adopt important legislative changes only after market forces have succeeded in circumventing existing outdated statutes. This certainly pertains to both interest rate ceilings on deposits as well as geographic restrictions on bank expansion. By this standard, the House should surely join the Senate in authorizing securities powers for bank holding companies. Such an action is necessary to confirm what is already occurring in the market place.

It is worth reviewing once again the reasons why securities powers for banking organizations are in the public interest. Banks--like all intermediaries--evolved as a kind of information processor able to collect, store, and evaluate the pertinent facts on actual and potential borrowers. With their information base, banks were in a better position to evaluate and choose among creditors than any other market participant. This knowledge permitted banks to choose the most successful and balanced portfolios and left many other prudential lenders with little choice but to hold significant portions of their own portfolios as claims on banks.

Three major developments have undermined the traditional returns to bank intermediation. The first was the growth of the institutional investor. Professional investment management brings to bear bank-like expertise to choose among potential borrowers, undermining one of the specialties previously reserved mainly for banks. But the professional investment manager--as well as the simultaneously evolving cash manager--was but a sleepy giant prior to the occurrence of the second major development--the information revolution. Information processing, as I noted, was the real basis for banks' value-added. The information revolution permitted a growing number of investors to cheaply tap and use a quantity of previously undreamed of up-to-date facts and knowledge about firms, instruments, and markets in order to make their own informed decisions and judgments.

With the institutional investor and the information revolution has come the third major development for banks--increased competition by those able to exploit expertise and knowledge without the constraints placed on banks. That competition has taken many forms with which you are all familiar: the money market fund offering liquid, safe, transactions balances; the corporation by-passing banks to borrow funds directly in the money market; the development and rapid growth of consumer and business direct lenders, often affiliated with nonfinancial businesses; the internationalization of financial markets, which opened up for both lenders and borrowers a seemingly endless range of instruments and markets; the creativity of the investment bankers not only to innovate and design new instruments, but also to act world-wide as true merchant bankers--underwriting and lending on their own account; and, finally, the creation of new financial instruments--such as financial futures and options, and interest rate and currency swaps--as well as a wide range of pricing algorithms and formulas, all of which provide low cost means of managing risk when coupled with rapid information processing.

It is no wonder that banking organizations in such circumstances have talked about level playing fields and sought increased powers. And it should also not surprise anyone that their successful non-bank competitors have marshalled their considerable resources to seek to sustain present limitations on banks' ability to compete. The questions relevant for good public policy are: if one is neither a banker nor a banks' competitor, is there any reason to care about these current and prospective developments? That is, will the public be affected one way or another by an evolving delivery system for financial services that increasingly bypasses banks? If the public is adversely affected, how can we change the rules consistent with safe and sound banking and financial market stability? If the public is not adversely affected, why not let the bank market share shrink?

These questions--which I think are the right ones--unfortunately have no easy answers. Indeed, the evidence is consistent with answers on both sides of the issue, but I believe that, on balance, it supports the position that we should care because the more limited powers for banking organizations are both unreasonable and inconsistent with the public interest.

Bank holding companies have not been sitting idle while markets have changed, but have tried to respond to the new competition, using the tools of their rivals. For example, they have increased their private placement activity in the U.S.; developed investment banking expertise abroad; provided investment advise and management; participated importantly in interest rate swaps; levied fees for old and new services that used to be part of the banking package; and have sought to obtain at least half-a-loaf by participating with their customers in the use of new techniques by guaranteeing credit market instruments for a fee and originating and selling loans to others. These responses have generated revenues that have tended to offset some of the lost business and have also, I think irreversibly, led commercial and investment banks into each other's business. But, despite these activities, banks have, in fact, lost share in the short-term business credit markets, and those losses have been among the highest quality credits. As a result, the overall quality of many banks' portfolios have suffered a decline.

Bank organizations need securities powers to compete in evolving markets and if they are unable to do so they will be unable to attract capital, a necessary prerequisite to a safe and sound banking system. As financial evolution continues, existing regulation will restrict the ability of banks to deploy their existing capital in the most productive way. Of course, not all of banks' capital is financial or physical; its most important real capital in fact is the expertise of its personnel. If that experienced staff cannot be used efficiently, because the services demanded by the market are not consistent with bank regulation, not only are banks disadvantaged, but financial markets too are made worse off, with society's resources not allocated in the most productive way.

If there is a strong analytical case that such an expensive reallocation of resources is in the public interest, the interaction of changing market demands, new competition, the information revolution, and unchanged law and regulation should cause bank personnel and other capital to leave banking and migrate to another institutional structure to deliver financial services. Traditionally, banks have not been free to allocate their assets as they choose. Rather, regulatory restrictions and the extension of a federal safety net have been applied in reflection of the important place banks have held as the basic suppliers of monetary assets, the safekeepers of deposit funds, and the central role they have played in the payments mechanism.

But both history and recent experience--including the stock market crash and its after-effects--suggest that the risk of securities powers can be managed effectively by bank holding companies. The history of the 1920s and early 1930s record no major bank failure caused by securities underwriting and dealing. Moreover, recent discussion of such powers often ignores the fact that the issue of abuse of securities underwriting by both banks and nonbanks--especially fraud and double-dealing--was addressed by the Securities Acts of the 1930s. Indeed, I believe it is very difficult to make the case that it's an acceptable risk for a bank to lend to a corporation long-term at a fixed rate, to guarantee its commercial paper, to provide it a long-term letter of credit, to engage in interest rate swaps with it, and to underwrite its securities in London or Tokyo, but not to permit that same bank organization to underwrite the same corporation's stocks and bonds in the United States. It is, quite frankly, an absurd position and as that absurdity becomes more obvious the law will ultimately be changed.

Securities underwriting and dealing probably is more risky than the average bank portfolio, although, as I noted earlier, I believe that risk is manageable. However, the additional risk is well suited to the bank holding company structure, which is designed to minimize the transfer of risk to the affiliate bank and to minimize the risk that the safety net will be extended beyond banking. The Proxmire-Garn bill passed overwhelmingly by the Senate, and the St Germain bill now before the House, both go beyond the typical affiliate-bank insulation that is now part of the Bank Holding Company Act, to build so-called firewalls between the bank and its securities affiliate (as both borrower and lender). The objective is to prevent the securities affiliate from obtaining any benefits from the safety net and to assure that the bank will not draw on the safety net because of its dealings with its securities affiliate. The arrangements spelled out in these bills are designed both to underline and to build into our institutional infra-structure a corporate subset--banks--that has access to the safety net, permits those banks to be associated with firms engaged in certain nonbank activities, but likewise limits the ability of the affiliates to benefit from the banks' access to the safety net.

I personally believe that these arrangements will work well and that we will, in fact, be able to use the proposed structure in the future for wider bank holding company powers. But there are other well informed observers who are concerned that firewalls will burn through just when they are needed the most. The issue is too important to leave to assertion or attempts to write rules which overcompensate for real or imagined risks. Securities powers lend themselves well to a test because the additional risks suggest that even if firewalls do not work, the risks to the bank affiliate are manageable; if it does seem to work, further experiments can perhaps be conducted, assuming that, as is true with securities powers, a case can be made that they are in the public interest. Whatever new powers are granted to Bank Holding Companies, the current Board of Governors is resolved to do what it can to assure that banks and their nonbank affiliates are, in fact, maintained as separate entities.

Indeed, it is, I suggest, of extreme importance for the future of our financial system that, as we reform it to recognize evolving developments, we do not at the same time knowingly or unknowingly extend the safety net over a wider and wider range of institutions. To do so would increase the moral hazard associated with institutions increasingly less constrained by effective market discipline. More importantly, perhaps, it would also invariably lead to more detailed government supervision and regulation of an expanding number and variety of our institutions. That is why I favor such high and wide firewalls and it is why I will do what I can as a member of the Board to assure that firewalls are maintained both conceptually and in fact.

There is a related concern that I would like to call to your attention. It is axiomatic today that our financial institutions compete world wide, and that the world's financial markets are increasingly interrelated. Not only was that clear in last October's stock market developments, but also it is no longer noteworthy that developments in the foreign exchange or Euro markets today promptly affect U.S. mortgage rates. In such an environment, our non-bank institutions--including affiliates of bank holding companies--might find themselves in the years ahead directly competing with entities that are, in effect, departments of a bank domiciled abroad. Since the bank and all of its customers will presume direct central bank support for the bank as a whole, the nonbank function and its customers will also presume at least indirect central bank support. "Universal banking," as I understand the term, puts less emphasis on the value of firewalls of the type evolving in the United States. This implies a broader degree of governmental support in world wide financial markets than is necessary or desirable. It would be a grim joke indeed if after so carefully restructuring our financial services industry, it was successfully argued that international competitive pressures were such as to require extension of the banking safety net to all U.S. financial firms in order to obtain an international level playing field.

As was the case with the bank capital convergence discussions, this issue is one that, with the globalization of financial markets, may benefit from international consultation and cooperation.