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ECONOMIC COMMENTARY

The Changing Nature of Our Financial Structure: Where Are We Headed? Where Do We Want To Go?

by Karen N. Horn

Changes in the financial markets have blurred the distinctions between banks and other depository institutions, and between depository institutions and other financial businesses.

In the midst of the blur, calls for reform have been coming from all corners, including financial institutions, regulators, the Administration and Congress, and the general public. The consensus is that reform is needed, but consensus ends there. Banks want to go into other businesses. Other businesses want to enter the banking business. Consumers want better services at lower costs. Regulators are concerned about increasing risks.

I think that it is time to step back from the details of the immediate debate, and ask some basic questions about financial market performance and the desirability of reform.

(1) Why is our financial system changing? (2) Why are we so concerned about changes in our banking structure? And lastly, (3) what are the options open to us in managing the evolution of the financial system?

Why is Our Financial System Changing?

We all know that our financial system is undergoing dramatic change. Banks have been moving into new activities. Some are offering brokerage services, some are selling insurance, and others are leasing airplanes, to name a few examples. Banks are moving into new geographic areas, sometimes because state legislatures are opening their doors for out-of-state entrants; sometimes by buying troubled banks or thrift institutions as part of an emergency rescue program; sometimes by exploiting regulatory loopholes that allow entry to another state on a limited-service basis—such as offering consumer loans across state lines. At the same time, other types of businesses, such as insurance companies, investment houses, mutual savings banks, savings and loan associations (S&Ls), and the finance company affiliates of major manufacturing companies and retail store chains, continue to enter fields traditionally identified only with commercial banks.

The traditional and still-operative legal definition of a commercial bank is quite clear: any entity both offering demand deposits and making commercial loans. Today, however, we have firms that offer only one or the other. They look like banks, but don't fall within the legal definition. These firms are referred to as nonbank banks. For example, Sears, Roebuck and Co. offers consumers deposit accounts, as does Merrill Lynch & Co., Inc. Other firms buy loans from banks, leaving the banks with the reduced role of originating and servicing loans. Consequently, some providers of financial services are regulated as banks and others are not. Moreover, even among the regulated firms, the incidence, effectiveness, and costs of regulation are uneven.

What accounts for this evolution? Quantum advances in telecommunications and computer technology now permit the rapid and low-cost transfer of funds and information worldwide. Partly in response to these opportunities, existing laws and regulations have been reinterpreted by regulators, legislators, and the courts. The resulting changes reflect a growing belief among some people that more efficiency can be achieved in the financial system with little cost to safety, soundness, and financial stability. Whether this is true or not and what the political and regulatory response should and would be to the issues of safety and soundness are, of course, the great unanswered questions underlying the current debate.

A dramatic change in the economic climate has provided an additional challenge for both financial institutions and regulators. The successful shift away from the inflationary environment during the period from the mid-1960s until the early 1980s has adversely affected some sectors of the economy, including agriculture, real estate, and energy, as well as debtor nations. Lenders with large exposures in these sectors are now paying the price for overexposure to borrowers who bet on continuing

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inflation. The resulting strains in the financial services industry have contributed to the greatest number of commercial bank failures since the Great Depression. One hundred twenty commercial banks were closed in 1985, and the federal bank supervisory authorities estimate that approximately 160 commercial banks will be closed in 1986.

The changing activities of financial institutions are, as one would expect, prompted by their drive for increased profits. The profit motive focuses the attention of entrepreneurs on opportunities arising from technological advances and product innovation in banking and finance. Many of the innovations have been productive and have improved the general welfare. However, they also have spawned new risks and new ways for banks and nonbanks to take risks.

Increased efficiency in our financial system is desirable, but what if it interferes with the safety and soundness of the system? Herein lies the crux of the debate that should be occurring among people interested in financial reform: Is there an efficiency/stability trade-off inherent in the banking and financial markets? And if so, to what extent must we constrain the participants' activities in order to preserve the stability of the financial system?

Our unwillingness to address this debate head-on, however, has led to an unfortunate proliferation of measures and proposals that focus more on the concerns of the hour, and of particular groups, than on the longer-term issues and opportunities. Many of the piecemeal, loophole-closing banking reforms we've seen so far have been just this type of response. As Albert Einstein once said, "A perfection of means and a confusion of ends seem to characterize our age." This current piecemeal approach to restructuring financial market regulation runs the risk of failing to address the most significant long-term problems. Furthermore, the outcome of a piecemeal approach to reform may well be something other than what we want.

I do not doubt that the set of products and production techniques that evolve from entrepreneurial profit-seeking are generally better than any government planning process could devise. But, in a sector of the economy where safety and soundness and financial stability have been long-standing assumptions, piecemeal changes in legislation or regulation in reaction to competitive pressures are likely to produce unintended compromises among these traditional public concerns. If the full range of public concerns remain valid, then regulators and, especially, legislatures, must periodically refocus on the ultimate objectives of regulation and modernize—that is, reform—the regulatory structure.

Why Are We So Concerned About Changes in Our Banking Structure?

When I speak of "we," I am referring to society at large. Financial markets ought to exist to serve the general public. Bankers, bank shareholders, the courts, and the existing bank regulators are but agents in that process.

The conflicts we currently face are not new. From the earliest chapters of our history, three sometimes conflicting concerns have played a key role in determining the regulatory framework for banks and financial institutions. These three concerns are efficiency, safety and soundness, and suspicion of market concentration. In fact, the suspicion of a concentration of economic power in banks ran so deep in our country during the nineteenth century that the constitutions of several states prohibited banking altogether. The last such state to remove the constitutional prohibition against banking was Texas in 1904.

Our historical concern for the safety and soundness of the banking system in particular arose from the unique role of banks and the perceived vulnerability of the banking system to losses of public confidence, with attendant consequences for commerce and industry. Since the creation of the Federal Reserve System in December 1913, banks have been distinguished from other types of financial and nonfinancial institutions by offering deposit accounts that would be used in making payments. Under public charters, these private institutions accepted deposits from and extended credit to customers, who could transfer the bank liabilities to others as a generally accepted means of payment. In this manner, banks assumed a central role in providing an elastic currency and a source of liquidity for all other entities in the economy, just as they do today.

Since 1914, banks and bank supervisory authorities also have recognized the importance of preserving public confidence in banks' capacity to meet their deposit obligations. Successful bankers maintained their depositors' confidence and thereby minimized the likelihood of a run on their bank. Government provision of deposit insurance (1933) and direct access to the lender of last resort (1914 and 1933) were added as a federal safety net to reinforce public confidence in banks.

Ironically, the addition of a public safety net, although developed to improve the soundness of the system, can have the effect of discouraging market discipline by allowing bankers and other financial market entrepreneurs to be less concerned about failure. Insured depositors have little incentive to scrutinize the safety and soundness of banks. Instead, it has become the obligation of the holders of the safety net—the federal deposit insurers, the Federal Reserve and the Office of the Comptroller of the Currency—to monitor and maintain the quality of banks' assets and the overall financial condition of banks. The traditional tools that we holders have used include supervisory examinations, capital adequacy requirements, lending limits, and the prohibition of certain kinds of transactions. Those prohibitions effectively separated commercial banking from investment banking, and from general lines of commerce, between 1932 and the 1980s.

The conflict posed between competition, innovation, and the drive for efficiency on the one hand, and safety and soundness considerations on the other hand, now has become quite divisive and confusing. For consumers to make informed choices among bank and nonbank providers of similar financial services, they must understand and be able to evaluate the financial conditions of those institutions. For banks, maintaining profitability and attracting new capital in a more competitive environment requires that they offer a widening range of services, albeit in a regulatory environment different from that of their nonbank competitors. Ensuring the safety and soundness of banks by the traditional regulatory prohibitions now seems to inhibit the competitiveness of banks, but how else might it be done? As long as regulation is costly for the regulated, there will be incentives for banks to attempt to expand or evade the banking supervisory structure and for nonbanks to offer bank-like services outside the supervisory structure for banks.

The present public policy dilemma in the financial services industry is becoming more intense as we try to establish a commonly accepted definition of a bank. If we are regulating banks, then what exactly is a bank? Should all institutions providing payments services be called banks? Should only those parts of an organization that provide payments services be called banks? Can the optimal balance between efficiency and safety-and-soundness objectives be achieved if nonbank providers of similar services are not regulated?

One thing seems clear. A new, more workable delineation of the roles of banks, regulators, and nonbank suppliers of financial services is needed if we are to be spared a chaotic working-out of the contradictions that abound in the present environment.

What Are the Options for Reforming the Banking Structure?

The underlying question that we should be asking is: What kind of banking structure do we really want? There is no single, clear-cut answer to this question, at least not one answer that would serve all people for all time. As indicated earlier, we want many things, some of which conflict. More than one alternative is open to us from the broad public policy perspective.

I shall briefly sketch four possible routes out of the present muddle. These options should promote careful thought about the basic principles connected with our choices. If we choose without considering these principles, we will be making a de facto decision that may be regretted at a later date.

I believe that the choices we make should be based on and consistent with general societal goals if we are to have much hope of avoiding future disillusionment with whatever new banking structure we adopt.

First Scenario:

The present piecemeal approach to reform of the banking structure could be continued, although it seems that this is intellectually the weakest of the four scenarios that I will discuss. Essentially, the forces that currently wield the greatest political power define the rules for banking, often without much regard for consistency with the goals and objectives we seek for the banking system, or without resolving the conflicts among them. This piecemeal approach most resembles the Christmas-tree, special-interest tax legislation that the Senate Finance Committee rejected in April 1986, rather than the sweeping tax reform bill enacted in its place. Nevertheless, in the past decade, we have changed some outmoded restraints on banking when a particularly acute problem needed resolution. On those occasions, almost everyone involved received a little bit of what was desired, but without conformance to a grand design. What was given easily then may be lost just as easily in the next round of banking legislation.

A decision to muddle through under the present system also ignores the underlying defects of a banking system that no longer reflects the central vision of the banking reforms of the 1930s. Reform through piecemeal action implies an inevitable whittling away of regulations originally designed to insure the safety and soundness of the banking system. Recent experience, however, suggests that this approach seems the most likely political course. Thus, when Congress considers an emergency interstate banking acquisitions bill, we should not expect a quick resolution either of the deeper conflicts regarding interstate banking generally or of the critical nonbank bank issues before us.

Second Scenario:

Congress could re-endorse the banking structure as it was last revised in the 1930s. This could be done principally by changing the definition of a bank and by closing the nonbank bank loophole. Without such a correction, banks would continue to coexist with retail deposit-taking institutions and wholesale commercial lending and investment banking institutions, neither class of which bears the regulatory costs of banking because, strictly speaking, neither constitutes a class of banks.

If Congress were to give a clear and unquestioned mandate to bank supervisory authorities to include nonbank banks in the present banking regulatory structure, however, then such a reinvigorated banking structure might be able to resist new assaults successfully for a while. An extreme version of this approach would be to question whether some other changes in banking structure undertaken in recent years in the interest of increased efficiency, such as regional interstate banking, compacts, and increasing the ceiling on federally insured deposits, were mistakes. Legislative reversal of those decisions might be considered in the interest of increased safety and soundness.

Armed with a new mandate to put the banking system back where Carter Glass, Jesse Jones, and Marriner Eccles wanted it to be, the regulators might be able to defend the shaky walls of the old castle without having to dig a new moat further out.[1] Any such shoring

1. Sen. Carter Glass formulated and sponsored the Federal Reserve Act, which created the Federal Reserve System in 1913. Jesse Jones was Chairman of the Board of Directors of the Reconstruction Finance Corporation (RFC), which during the 1930s helped restructure the banking industry and laid the groundwork for the nation's recovery from the Depression. Marriner S. Eccles was chairman of the Board of Governors of the Federal Reserve System from 1935 to 1949. He helped restructure the Federal Reserve System during the Depression and successfully promoted adoption of Title II of the Bank Act of 1935, which gave the Federal Reserve System the responsibility for furthering economic conditions that are conducive to business stability.

up of the present fortress would, of course, be challenged widely, especially by the more entrepreneurial sectors of the banking industry and by nonbanking enterprises that have entered banking markets. If this course were our choice, we regulators would need a clear mandate from Congress to bolster our chances of prevailing in the courts.

In its favor, this scenario does have the virtue of consistency with a fair amount of United States financial history and regulatory tradition. Working against it, however, is the thrust of our present general value structure, which seems to favor efficiency goals over those of safety, soundness, and stability. In my travels, I hear no politically effective voices speaking up in defense of this old order. After all, this may well be an approach that, as I mentioned earlier, has already been so completely undermined by the press of events and recent decisions as to be beyond repair.

Third Scenario:
It is possible to undertake a reform of the banking structure that would be somewhat comprehensive, unlike the piecemeal approach, yet that would not amount to turning back the clock. Congress would have to enact legislation that would affirm our longstanding belief that banking is special and, further, that would delineate more clearly the separation between commercial banking and a few other economic activities. Even if commercial banking is special, any new delineations of its boundaries probably would have to encompass powers beyond those possessed by banks today. Also, any such delineation would probably have to reduce the powers of new nonbank entrants into the financial marketplace, or at least subject these firms to a regulatory and/or supervisory constraint more comparable to those placed on banks today. Preferably, the new lines of separation would be drawn and accompanied by a statement of political intent that would guide future regulatory and court decisions implementing the new rules. This approach could entail the following features:

- A new definition of banking would be prepared, closing the nonbank bank loophole by redefining banking to include all entities engaged in taking retail deposits that are subject to withdrawal by (1) check or other draft payable to third parties, possibly including money market mutual funds; or (2) debit card or other electronic method of transfer. Congress would have to specify clearly which types of organizations could own or control banks.

- Banking powers would be broadened to include such activities as real estate and insurance brokerage; underwriting of municipal revenue bonds, commercial paper, and mortgage-backed securities; and offering investment advice to institutional customers.

- Minimum capital and risk-adjusted capital requirements would be strengthened to the extent required to cover risks associated with nonbanking ventures.

- Risk-adjusted deposit insurance premiums would be considered, either separately or in conjunction with reductions in federal deposit insurance limits, to levels that essentially protect retail depositors but not wholesale or institutional depositors.

- Access to the lender of last resort would be limited, as at present, to the provision of necessary liquidity to depository institutions on the security of sound assets.

The debate that would accompany enactment of this scenario would answer the basic questions and provide direction for the evolution now going on in the financial service markets. We would have a framework for evaluating the trade-offs between public benefits of efficiency in financial markets on the one hand, and safety and soundness on the other. Federal Reserve Chairman Paul Volcker essentially called for just such a reexamination of our objectives and procedures in his testimony before a subcommittee of the House of Representatives on June 11, 1986.

Fourth Scenario:
A strong move toward a rigorous, direct free-market approach to reform of the banking structure is another possibility. Our society could choose more clearly in favor of market-oriented efficiency, explicitly recognizing the possible consequences of de-emphasizing safety and soundness in the provision of financial services. For example, in his recent book, *Risk and Other Four-Letter Words,* Walter Wriston, former chairman of Citicorp, notes explicitly that no bank should be considered too large to be allowed to fail. To paraphrase Mr. Wriston, those banks or bank holding companies seeking greater returns must be prepared to assume greater risks of failure. Acceptance of that risk of failure is the price paid by market participants for the right to engage in a greatly expanded scope of activities that carry with them potentially increased risks of failure.

Within this scenario, and within the greater context of United States history, some degree of separation between banking and other lines of commerce may still be desirable and inevitable, while leaving much more room for innovation. A free-market approach could include the following elements:

- **Free Entry**

There would be free entry into the "deposit-taking banking system." Nonbank banks, such as Sears, Roebuck and Co., could remain in the banking industry, but would be subject to compliance with applicable bank examination and bank holding company inspection requirements, including inspection at the parent company level. There would be no federal barriers to interstate provision of financial services, but the states might continue to erect barriers. Federal barriers to entry into particular states would be eliminated unless potential entrants refused to provide the information required by state or other relevant bank supervisory authorities.

• Equal Treatment
For a competitive market to work well, the environment and the terms on which firms compete must be substantially similar. To achieve competitive equality might require far-reaching changes. For example, all depository institutions would be treated alike with respect to required reserves on deposits and the incidence of other costs of regulation. Taking this principle to its extreme, special sector lenders competing with depository institutions would be turned over to the private sector and cut off from access to the United States government debt market. Entities such as the Federal Home Loan Bank System and the Farm Credit System would be required to compete for funds with commercial banks on an equal, unsubsidized footing.

• Market Protection
The current federal systems of bank holding company inspection, bank examination, and bank supervision generally would be largely dismantled. Instead, private sector information systems, possibly including expanded roles for the rating agencies, would supplant the federal bank supervisory authorities. Antitrust, antifraud, and other public policy objectives for protecting the rules of a free market would be pursued by existing state bank supervisors, by the United States Treasury and Justice Departments, and by agencies such as the Securities and Exchange Commission. Some minimal form of actuarially sound federal deposit insurance would probably be useful. Coverage would have to be reduced from $100,000 to perhaps $5,000 or $10,000 per insured depositor, to protect small depositors who might have difficulty appraising the riskiness of depository institutions.

• Failure
Depository institutions would be permitted to fail, just like other nonbank business firms. While the Federal Reserve could provide advances secured by sound assets to meet liquidity problems and to forestall bank runs, bank solvency would not be guaranteed. Depository institutions losing the confidence of depositors and/or shareholders would be forced to merge or liquidate assets in order to meet liabilities. Shareholders, creditors, and depositors with accounts exceeding the insured deposit limits would bear a substantial risk of financial loss. Taxpayers, however, would not be exposed to loss, either directly or through federal deposit insurance agencies. The possibility of failure would exert powerful disciplines on market participants regarding financial decisions: It would force management to be more prudent in lending and in providing capital and loan-loss reserves, and it would force shareholders, depositors, and creditors to acquire more information about the institution, and to monitor its activities. Without the discipline of the marketplace, a drive for efficiency can be very dangerous from the general public's viewpoint. The consequences of bad private decisions might fall on public agencies and, ultimately, on the taxpayers. Consequently, the public benefit of a more competitive financial system may be far less valuable than first appearances might suggest.

In reviewing recent experiences with thrift institution failures in Ohio and Maryland, and with Continental Illinois Bank, society appears uncomfortable at present in fully embracing the free-market scenario, despite its intellectual appeal. However, it is an approach that is worth keeping in the back of our minds as we consider the other alternatives.

Conclusion
Of my four scenarios, the one I believe we ought to pursue, at least in the immediate future, is the third scenario, involving extensive Congressional clarification of the lines separating banking and commerce. Players in the financial services game now have every incentive to exploit technological innovations and loopholes in existing legislation. This has become, after all, a very competitive market. The task that lies in the hands of the public is to decide what are reasonable activities for banks and other financial institutions. Such a decision probably would entail a further loosening of the reins on the financial services industry, as is occurring in many sectors of the United States economy. It would also involve making some decision about the relative importance of safety and soundness in banking that we have avoided making until now.

The bulk of the responsibility for ensuring the safe operation of our financial system should be in the hands of the financial institutions themselves, not in the hands of regulators. One of the surest ways of achieving this goal is to restructure our deposit insurance system. The cost of bank failure should fall, in this sequence, on shareholders, subordinated creditors, general creditors, uninsured depositors, and only then and last, the deposit insurance agencies. Risks should be priced so that the incidence of the burden on taxpayers is nonexistent, if possible. In fact, you should notice that I have avoided any extensive discussion of proposals for reform of the banking structure that involve a greater element of taxpayer subsidy to bank customers or bank management or shareholders than we already have.

Perhaps there is room for public subsidy in instances in which public policy decisions caused costs to fall disproportionately on some classes of borrowers (or lenders). If so, logic dictates a one-time subsidy to facilitate adjustment and to cushion shocks, not an ongoing system that encourages imprudent decisions. At any rate, a new structure of deposit insurance could provide managers, boards of directors, and shareholders of our financial institutions with the incentive to make wiser, more prudent decisions.

Congress and the bank regulators are just now beginning to address the type of banking structure we need. The adoption of risk-based capital standards or risk-adjusted deposit insurance premiums, or both, should be helpful in instilling more market discipline in the financial services industry. The most important task ahead of us is the development of a new regulatory framework that is internally consistent: that is, with rules and regulations that are consistent with one another, and that encourage the type of behavior that we want from our financial institutions.

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