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Statement of

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Subcommittee on Telecommunications,
Consumer Protection, and Finance

of the

Committee on Energy and Commerce
of the
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Mr. Chairman, I appreciate the opportunity to appear before this Subcommittee and share with you some of my personal observations about emerging trends in the structure of our banking and financial system and their implications for public policy.

It seems to me that any discussion of this subject must start with an appreciation of the historic and ongoing role that "banks" have played in the day-to-day functioning of our financial and economic system. It also seems to me that as we grapple with this very complex and very important subject, we need a systematic and intellectually consistent framework for analysis within which we can find solutions that are reasonable, functional, and that serve the public interest. As the Subcommittee knows, I have attempted to provide one such framework for analysis in my essay, "Are banks special?" Since much of what I have to say today draws on that analysis, I would like to submit that essay, together with this statement, for the record.

Spurred by a variety of factors which need not be restated here, the pace of financial change and innovation here in the United States and around much of the industrialized world has taken on an almost breakneck pace. Almost daily we read in the financial press of some event or some development which seems to challenge one or more aspects of existing law or regulation or which seems to undermine some aspect of the once conventional wisdom about the structure of our financial system. To put it somewhat more graphically, it is, indeed, very hard to tell the players without--or even with--a scorecard. It is in this environment that the legislative moratorium on the formation of "nonbank" banks (and related matters) suggested by the Federal Reserve seems to me to make very good sense. More generally, in this environment, with all of its competitive implications, it is not surprising to find a growing sense of urgency regarding the need to update some of our laws and regulations as they pertain to the structure of banking and the financial system.

I share in that sense of urgency in part because I believe that banking functions in particular and financial activities more generally are too important to allow a helter-skelter of events to run their course in the hope that events will shake out in a manner that is consistent with the public interest. While that sense of urgency is understandable, I believe it is important that we not lose sight of the fact that, for the last five decades, our banking system has worked remarkably well. Indeed, over the past decade alone, the banking system has weathered a number of storms and, in the process, demonstrated a truly impressive degree of underlying strength and resiliency. The demonstrated capacity of the banking system to weather these storms also forcefully underscores the public's deeply entrenched confidence in the safety and soundness of the banking system. To some considerable, but admittedly unmeasurable, degree public confidence in the banking system has its roots in the legislative and regulatory framework--much of it dating back to the 1930s--within which banks and other financial institutions operate. The point I am working toward should be obvious. Namely, as we proceed with the urgent task of reshaping the legislative and regulatory framework within which banks and other financial institutions operate, we must not lose sight of those characteristics of the present system that have permitted it to work so very well for 50 years.

In general, I believe most of us can agree on the broad objectives that should be served by the effort to reshape our banking laws and regulations in a manner that is more in keeping with the realities of the contemporary marketplace. We want a system that promotes--indeed encourages--fair and reasonable competition in the provision of banking and financial services; we want a system that provides consumers and businesses--small or large--with access to the most cost-effective means of conducting their financial affairs; we want a system that permits the monetary authorities to conduct monetary policy with a reasonable degree of efficiency; and, most of all, we want a safe and sound system which will preserve, if not solidify, the public's confidence in the banking system. These objectives--and others that could be added to the list--are easy to articulate and, taken individually, are easy to subscribe to. The problem arises, however, because specific objectives may often be in conflict with each other. To cite just one such conflict, the objective of competition may, at some point, be fundamentally in conflict with the objective of safety and soundness. Thus, the task at hand is one that inevitably entails the weighing and balancing of sometimes conflicting objectives in a manner that in the final analysis best serves the public interest.

The approach I have suggested in "Are banks special?" seeks to balance these considerations by looking first at the unique functions historically associated with banks. It identifies three such unique functions: (1) that banks issue transactions accounts--that is, liabilities that in fact or perception are payable on demand at par and are readily transferable to third parties; (2) that banks are the backup or standby source of liquidity and credit to all other institutions; and (3) that the banking system is the transmission belt through which monetary policy is conducted. The essay goes on to suggest that in order for banks--or any class of institutions--to perform these functions it is important that their financial strength--the quality of their assets, the depth and quality of their capital, etc.--be such as to justify public confidence in their strength and vitality. In turn, these considerations are, fundamentally, why it has been deemed in the public interest to have a public safety net in the form of deposit insurance, access to the discount window, and particular forms of supervision and regulation associated with banks.

This framework, while perhaps a bit more conservative than others, is not one that says that banks should be precluded from engaging in "nonbanking" activities nor that nonbank organizations should be precluded from engaging in banking activities. To the contrary, the analysis is quite compatible with those results. At the same time, however, it does suggest that just because a particular activity can be classified as "financial" in nature, it does not necessarily follow that such activity should be fair game for banking organizations. And, it clearly suggests that the historic separation of banking and commerce more generally still seems to make eminent good sense.

Within that framework, it seems to me that our efforts to decide which activities are appropriate for banks must start with a workable definition of a bank. The definition I have suggested is simply that a bank is any institution that issues liabilities that are payable on demand at par and are readily transferable to third parties--i.e., banks issue transaction accounts. Using that or some other definition as a point of departure, determining what activities are appropriate for banking organizations can then be guided by the following:

> <u>First</u>, I believe we must keep in mind that questions of bank powers and bank ownership are, in practice, one and the same. That is, if we say that a banking organization can engage in a particular set of "nonbanking" activities, it seems to me to follow, as a matter of logic and practicality, that another firm engaged exclusively in those same activities can own a bank, whereas a firm engaged in a still broader range of activities should not be permitted to own a bank.

Second, nonbank activities of banks should be financial in nature or closely related to banking, but they should also be activities that are not unduly risky and they should not be activities that can impair the impartiality of the credit decision-making process. These criteria suggest to me that while there is a wide range of financial activities that may be wholly appropriate for banking organizations, they may also be activities which--while unambiguously financial in nature--should not be engaged in by banking organizations.

Third, the bank holding company structure provides a vehicle which can help insure that the pursuit of nonbanking activities by bank organizations does not impair the soundness of banks and the soundness and objectivity of their decision making. Indeed, the separate capitalization of subsidiaries of bank holding companies and the restrictions against self-dealing contained in Section 23-A of the Federal Reserve Act can be thought of as something of a firewall that provides a measure of protection against conflicts of interest and against the risk of loss in nonbank activities impairing the financial condition of the bank itself. However, I for one am not persuaded that these protections can take on failsafe characteristics, particularly since the strength of the firewall is likely to be tested only in times of peril.

Let me state it differently. I think it may be asking too much to expect that banks can stand by with the same detached objectivity when faced with a failing or troubled affiliate as might be the case with an unaffiliated firm. Similarly, I think it may be asking too much of even relatively sophisticated investors, much less small depositors, to expect that

that can readily disassociate the problems of a subsidiary of a bank holding company from the bank itself. Partly for these reasons, I believe that we should take a very hard look at whether banks should be permitted to engage in activities which--while financial in nature--may entail excessive risk and may threaten the objectivity of the credit decision-making process. In time and under some circumstances, it may make sense to fold all financial activities into banking organizations, but for now, I would strongly favor a tempered approach.

Regardless of where the line for permissible banking activities is drawn, more widespread combinations of banking and nonbank financial institutions is inevitable. In such a setting, I believe it is fair to speculate that the blending of financial institutions and financial functions will work in the direction of creating still greater interdependencies in what is already a highly interdependent and interconnected financial system domestically and worldwide. However, over some reasonably long period of time, it is not clear to me that broader powers for banks--in and of themselves--will produce a degree of interdependence that would be materially different from what would occur in any event. Thus, regardless of its causes, the reality of extraordinary financial interdependence does imply that the task of isolating and containing problems of a financial nature becomes more difficult, as we have seen during the past year or so. In this context, even if the blending of financial functions and financial institutions does not directly and materially increase the degree of financial interdependence from what would occur in any event, it may produce a situation in which it is more difficult to quickly identify the dimensions and reach of problems when they arise and to identify the circuit breakers that need to be thrown in order to prevent a particular problem from taking on systemic characteristics. None of this, in my judgment, need stand in the way of the expansion of banking activities and the associated blending of financial functions and institutions but it does, in my judgment, underscore the case for the tempered approach I suggested earlier.

As a related matter, the deregulation of banks--whether in the form of the de facto elimination of Regulation Q or the expansion of banking activities--produces an acute dilemma. That is, deregulated banks, at least at the margin, are more risky. In principle, therefore, these institutions should be more subject to the disciplines of the marketplace including the ultimate discipline of failure. Yet, it is even more compelling that concerns about systemic risk and public confidence in the banking system mandate that we maintain a public safety net under the banking system. Stated differently, one of the most difficult and important questions raised by banking deregulation relates to the task of dovetailing the evident need for greater market discipline on banking organizations with the need to maintain public confidence in the banking system. We need a public safety net that is strong and effective, but also one that permits market discipline to play its natural role.

As I said earlier, I, like many others, look upon the current situation with a sense of urgency insofar as the need for legislative remedy is concerned. The tides of technology and the marketplace cannot be held back and, in a fundamental way, they should not be held back. These forces for change offer the potential for a more competitive, a more innovative and a more vital banking and financial system. At the same time, however, they dramatically underscore the need for discipline and prudence in financial affairs generally and in banking activities in particular. The task at hand is formidable, yet manageable. As we proceed, however, it seems to me that the overriding consideration should be to preserve and maintain a strong banking system in which public confidence can safely reside.

 Thank you.