The Proposals for Reform
that are "On the Table"

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I would like to do two things this afternoon in discussing reform of the banking system or, perhaps more properly, reform of the financial services industry. First, I intend to review the major reform proposals on the table--principally the Treasury proposal but those of Congressmen Gonzalez, Wylie, Barnard, and Senator Riegle as well--and comment critically on some of their key provisions. Then, I will offer a personal "vision" of a set of desirable reforms and of the financial system of the future. Let me admit, right off the bat, that I have a strong, and growing, bias in favor of market based reform.

By way of overview, it seems to me that serious proposals for modernizing the financial system contain three broad categories of provisions, differing principally in the emphasis accorded each. Without being terribly rigorous, these categories are:

---supervisory and regulatory reform, including changes in deposit

*Views are those of the author and not of the Federal Reserve System.
insurance coverage and pricing, capital based supervision, and prompt intervention;

--geographic and activities expansion for banks, including nationwide banking and branching; broader securities, mutual funds, and insurance powers, culminating in the establishment of financial services holding companies; and, finally, the combination of banking and commercial firms;

--regulatory agency restructuring, that is, the "super" supervisor concept.

Reform Proposals on the Table

Let me discuss these provisions in the order opposite to the way I just presented them. Consolidation of the federal bank regulatory agencies is
included in the latest Treasury proposal--there would be two rather than three federal bank regulators; the Wylie bill, which also proposes two agencies along the lines of the 1984 Bush Task Group recommendations; and the Gonzalez bill, in which one regulator is proposed.

The issue of the number and responsibilities of the Federal regulatory agencies seems to me both the least intellectually stimulating and least significant of those currently before us. No doubt, there is frustration and added expense for bankers in dealing with more than one federal regulatory agency. Indeed, I know there can be both frustration and incremental expense in dealing with one large, geographically fragmented agency with imperfect internal communications.

Despite this concession, I do not see reform of the bank regulatory agencies as one of the truly critical public policy issues of the day. Surely such reform would contribute little in the broad scheme of things to better managed, more profitable institutions that better serve a broad, diverse range
of customers. Indeed, as a practical matter, it seems far more sensible to
address first the more substantive aspects of banking reform and then
establish a regulatory structure appropriate to the new shape of the financial
services industry, rather than try to prejudge or project an effective,
politically acceptable, regulatory structure.

We get much further into matters of substance when we consider questions
of geographic and activities expansion and bank ownership. The Treasury
essentially proposes full nationwide banking and branching, a position with
which I agree. (Surprisingly, this issue is not addressed in the other pieces
of legislation submitted thus far, except in Congressman Wylie's bill.) Aside
from what geographic expansion may do for efficiency and profitability of bank
operations, it promises a wider range of institutional choices as well as terms
and conditions on deposits, loans, and other services for bank customers, and
therefore is to be welcomed, indeed promoted. I might add that in many
respects nationwide banking is becoming a fait accompli, so we might as well
let it happen on an efficient and rational basis.
Viewed narrowly, so-called powers expansion—into equity underwriting and other securities activities now constrained, full service insurance activities, and mutual funds—is constructive, although I strongly suspect there will be fewer new entrants and less activity by banks in these areas than expected. But, we don't have to prejudge outcomes. I should note that the Treasury proposal and Barnard bill are both quite far-reaching in this regard. Implicit in this endorsement of activities expansion is permission for nonbank financial services companies to own banks and vice versa, thereby establishing and accepting the financial services holding company concept.

As to commerce and banking—a concept also endorsed by Treasury and Barnard—I must admit to some lingering caution and unease in this area. What principally concerns me is preservation of the independence and integrity of the credit decision making process, something I fear could be compromised, at least to a degree, if commercial and banking firms unite. Further, it seems to me that profitable banking organizations will attract capital and unprofitable ones will not, irrespective of rules governing banking and commerce, although
some commercial firms may want to enter banking to exploit advantages in technology, customer base, or other perceived opportunities.

The caveat with which I began this discussion several moments ago is critical, however. To paraphrase, I said viewed narrowly, these things are appropriate, but in fact they cannot be viewed narrowly. In this matter, I happen to agree with Senator Riegle, who said last month: "We need to make sure we have reformed the deposit insurance system and the supervisory system so as to guarantee that new powers do not mean unnecessary and unwise new risks to the taxpayers." The fact is, financial reform has to be a coherent package.

This brings me to the first issue I mentioned and the most important set of reforms, namely those addressing deposit insurance, bank capital, and prompt supervisory intervention. These issues receive a great deal of emphasis in the Treasury proposal, in Riegle's bill, in Gonzalez' bill, and in Wylie's and Barnard's as well. I will not dwell on the details of these aspects of the reform proposals, except to say that in general there is an attempt to limit
deposit insurance coverage, price it based on risk factors, strengthen bank capital, and intervene promptly if and as bank capital deteriorates.

Conceptually, there is little to object to in all this, but in practice these measures are inadequate, and inadequate on two distinct levels. First, the proposed reforms of the deposit insurance system do not address the fundamental flaw in the system, namely the moral hazard problem. As matters now stand, risk taking in banking is underpriced and, as a consequence of this mispricing, depository institutions whose liabilities are insured take on more risk than they should, especially since insurance coverage is virtually without limit. In fact, as matters now stand, it is possible for even insolvent institutions to increase their insurance coverage and the size of their operations. The results of current deposit insurance policy are evident (in the extreme) in the savings and loan industry and in the string of earnings "disappointments" at many large commercial banks over time. I will have some suggestions for meaningful deposit insurance reform in a moment.
The second level on which many of the supervisory and regulatory reform proposals are inadequate is in their practical implementation. We may agree on the desirability of higher capital standards but, so far as I know, no one is seriously proposing a return to the capital levels prevailing before federal deposit insurance, although presumably those are roughly the levels required to contain moral hazard. As it is, some institutions have difficulty meeting the modest tangible leverage ratio (tangible tier one, essentially equity, capital as a percentage of tangible total assets) now in effect.

Moreover, how do you rigorously maintain capital standards and impose prompt supervisory discipline without market value accounting? It seems that much, perhaps too much, is left to the discretion of the bank supervisors, a problem also encountered by suggestions for risk based deposit insurance premia administered by supervisors. As the problems of the industry suggest, we may already be asking the supervisors to do too much.
Another example of excessive reliance on supervisors may be found in the so-called "credit crunch" controversy. Personally, I think this is one of the more exaggerated issues of the day. But to the extent that there is a credit crunch, it has resulted in part from the inherent difficulties bank examiners have in distinguishing between "good" and "bad" real estate loans. Do we really want to introduce more supervisory discretion in banking?

Vision

In thinking about the banking and financial system of the future, and the principles which, from a public policy perspective, might guide its evolution, several considerations come to the fore.

1) Financial reform should not be concerned per se with the profitability of a particular class of institution nor with returns for the industry as a whole. Rather, reform should emphasize the interests of the customers of financial services firms—households, big business,
small business, municipalities, and so on—and assure that customers are well served.

2) Similarly, reform should be directed to shape a financial system which protects the interests of taxpayers.

3) To the extent that the United States has an international comparative advantage in the provision of financial services, reform should permit this advantage to be exploited.

4) Within the regulatory limits that follow from the three preceding principles, decisions about which activities to engage in, which services to provide, pricing, and where to operate should be left to the management of banks and other financial services firms.

How do we implement these principles? I doubt that government officials can or should provide a detailed road map. Preferably, we call on the market
or, more precisely, make it possible for market forces to play an increasing role in determining the future shape and scope of the banking and financial services industry.

To accomplish this, we must start by correcting the incentives and redressing the misallocation of resources resulting from the current deposit insurance system and the "too big to fail" doctrine. As matters now stand, we have a system which relies on extensive regulation and supervision to offset the moral hazard inherent in deposit insurance. When this fails, as in the savings and loan industry, the taxpayer is at risk.

To help straighten out incentives and increase market discipline on insured depository institutions, we at the Federal Reserve Bank of Minneapolis have previously proposed a form of coinsurance. The more I think about this idea, the better I like it. The basic elements are as follows. Over and above the nominal $100,000 insurance limit (and only one insured account, in the system, per customer), depositors would explicitly be at risk for, say,
10 percent of their deposit, so that insurance coverage over $100,000 would be 90 percent, in contrast to the de facto 100 percent coverage prevailing today. This 10 percent exposure, we believe, would give (large) depositors ample incentive to pay attention to the calibre of the institutions with which they do business, again in contrast to current practice where such incentive is largely lacking.

Other changes would follow from this one. For example, increased disclosure of banks' financial condition is likely, especially as strong institutions find it in their interest to make their virtues known. A much more fully developed market for information about the condition of banks would emerge over time. Depositors might also become more interested in diversifying the list of institutions with which they do business.

Several caveats about this proposal are, of course, in order. Such a change in deposit insurance coverage cannot be introduced overnight. A period
of preparation and phase-in should be allowed, so that both banks and depositors can adjust. Moreover, coinsurance is not, in my view, a substitute for supervision. Rather, it is a complement to it that relies on market discipline to a greater extent than is the case today.

Further, coinsurance is likely to increase the frequency of bank runs. Before recoiling at the thought, we should recognize that this is not all bad. On the one hand, runs that occur at open but insolvent institutions represent a market version of prompt intervention and are desirable, especially if one believes there is excess capacity in banking. On the other hand, runs that occur at solvent institutions or threaten to become systemic are problematic, but there is the Federal Reserve discount window to provide liquidity. That is why the window was established in the first place.

I recognize, in contemplating a higher incidence of bank runs, that there may be an understandable reluctance to embrace coinsurance. But it is not as if the current system has worked all that well; witness the cost of resolving...
the savings and loan problem borne by the taxpayer. Think about the current
debate about how to "recapitalize" the FDIC.

There are at least two other significant advantages of coinsurance beyond
the market discipline it directly imposes. First, it is the only reform
proposal of which I am aware that, at least potentially, provides a vehicle for
eliminating the pernicious doctrine of too big to fail. While many, perhaps
most, analysts, policymakers, and bankers agree that too big to fail must be
discarded as a policy, such agreement in itself is insufficient. A mechanism,
a method for terminating the policy must be identified.

The reason that coinsurance provides a vehicle for dealing with too big to
fail is that it caps the size of depositor exposure and, if desired, the
exposure of other creditors as well when a bank fails. Remember that under the
coinsurance proposal a depositor is at risk for only 10 percent of his balance
over $100,000. Thus, spillovers are held to modest proportions, potentially
allowing supervisors to treat institutions of any size identically. In the
Continental Illinois case, perhaps the precedent setter for the too big to fail policy, concern for the large number of small banks which had correspondent relations with, and considerable exposure to, Continental was a major impediment to closing and liquidating the organization.

Coinsurance could also quickly end the debate about the advisability of imposing market value accounting on banks. Assuming that coinsurance would contribute to effective depositor discipline on insured institutions, insisting on marking a bank's balance sheet to market would be unnecessary. Depositors would use all available tools and make whatever calculations they felt necessary to assess the safety and soundness of the institutions with which they conduct business.

With increased market discipline, regulators should be far less concerned than they are today about the range of activities in which insured institutions engage, whether such activities are in the bank or in the holding company, or the geographic scope and size of the operation. So long as large depositors
understand they are truly at risk and act accordingly, risk taking will be more accurately priced than it is today and bank management will have an incentive to act more prudently. With the proper incentives in place, we can leave it to bank management to pursue profit opportunities by determining the services they want to provide and where they want to provide them.

In leaving these decisions to bank management, I suspect we will end up with a financial services industry at least as diverse as, and more competitive, domestically and internationally, than the one we have today. Some firms will operate internationally, some will confine themselves to a local market. Some large firms will carve out profitable niches and stick to them; other large firms will aggressively expand both service lines and geographically. There will be mergers and there will be consolidation, and over time there will probably be fewer firms doing a traditional banking business than there are today. But this hardly need concern us, given the large number of firms in the business.
Conculsion

In my view, the essential elements of reform of the banking system are clear. We should increase market discipline on banks by introducing coinsurance, a step that could also facilitate termination of the policy of too big to fail. Once coinsurance is in place, banks should be permitted to move ahead as they see fit with geographic and activities expansion. Legislation will of course be required, so none of this is simple. Nevertheless, I am convinced it is the best of the alternatives.