THE FED VIEW OF BANKING REFORM LEGISLATION

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The Fed is broadly supportive of the thrust of the Treasury proposal, and of much in both the House and Senate bills on banking reform. This legislation recognizes that the banking industry needs sweeping change and provides for: (1) recapitalization of the Bank Insurance Fund, (2) tougher capital standards backed by prompt corrective action, and (3) expanded powers for well-capitalized banks.

To take an apt quote from Chairman Greenspan's testimony: "The best protection for the insurance fund is to be certain that we have strong banking organizations."[1] Thus, the Fed strongly argues, and I agree, that piecemeal legislation will not be enough. Instead, we need to get at the root problems of weak banks.

Major Elements the Fed Supports

I'll begin by enumerating for you very briefly the major elements that the Fed supports. The linchpin of the reform in all the proposed legislation is a mechanism for prompt corrective action triggered when a bank's capital falls below minimum standards. The Fed strongly supports the plan. It would not only reduce the likelihood of failures, but it would also lower the insurance fund's cost of resolving them if they do occur.

The Fed also supports some cutbacks in deposit insurance coverage, particularly for most or all pass-through and brokered accounts. This provision introduces market discipline while retaining protection of the small depositor, which was the original intent of deposit insurance.

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[1]From a statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 23, 1991.

Finally, the Fed strongly supports expanding both the geographic scope and the activities of banks. Authorization for interstate banking and branching is an idea whose time has clearly come. States already have been moving in this direction for years. And it could help banks cut their administrative costs by allowing them to collapse subsidiaries into branches and eliminate unnecessary layers of management. In addition, allowing well-capitalized banks to take on new activities is a critical part of equipping banks so that they can compete effectively in the financial industry here and abroad. The new activities, such as securities underwriting, would build on banks' expertise in evaluating projects and monitoring companies.

Some Areas of Concern to the Fed

Now let me move on to three areas where the Fed has concerns. Regarding increases in deposit insurance premiums--both to fund BIF recapitalization and to introduce risk-based deposit insurance premiums--the Fed strongly urges caution. The Fed is concerned that premiums are already high, and higher premiums would just make weak banks weaker. Moreover, risk-based premiums may be redundant if we already have risk-based capital requirements backed by prompt corrective action.

Market-value accounting is another area where the Fed urges caution. Proposed legislation calls for studies of the feasibility of market-value accounting and efforts to apply it where feasible. What is now envisioned is the balance sheet in book value and supplementary schedules of bank securities assets marked to market. The Fed can live with this, but is wary of attempts to mark all bank assets and liabilities to market. Since most bank assets aren't actively traded, their market values must be estimated, and therefore will be imprecise.

The issue of "too-big-to-fail" has gone through a number of iterations. The latest revision to the Senate bill, in fact, moved closer to the Treasury proposal, by permitting a case-by-case exception to the least-cost resolution rule. However, both congressional bills want to tighten the conditions for making exceptions. They call for restricting ailing banks' access to the discount window by requiring the Fed to: (a) get certification from the primary supervisor that the bank is viable, (b) lend only for a limited number of days, and (c) rebate the FDIC if the bank fails.

The Fed's concern here is with "systemic risk." The argument is that the failure of a large bank could lead to other bank failures--possibly throughout the correspondent bank network--resulting in disruptions to the macroeconomy and the payments system.

A Personal Perspective

Let me now offer my own views. First of all, I share in the Fed's strong support of prompt corrective action, some limitation of deposit insurance coverage, and expanded powers. And I'd like to spend a few minutes on those and other issues in financial reform.

I'll begin by underscoring the importance of putting less emphasis on increases in premiums and more reliance on bank capital. There's a direct relationship between the capital level requirements and the appropriate size of the insurance fund and its premiums. Theoretically, with high capital and prompt corrective action, closure occurs before a bank's net worth is exhausted, and the insurance fund and its premiums can be very small, or even zero. If we make the capital requirement low, then of course net worth will be exhausted, and the fund must be large to cushion the losses.

There's no important cost difference to banks; high capital or high premiums will be equally costly. There is an important difference, however, in the incentives banks face, especially if we continue to use level premiums: With low capital, the incentive to gamble at the expense of the insurance fund remains, posing future problems. And the healthy banks implicitly will be underwriting the risk-taking of the weak banks.

Theoretically, a risk-based premium structure could avoid some of these effects. But, in the long run, I believe that good banks and the banking system will be better off "self-insuring" with higher capital than relying on a large public insurance fund. And this need not mean that banks will be less profitable. Indeed, some studies at the Board of Governors indicate that high-capital banks are more profitable.

A second, related issue concerns the use of market value accounting. While no one would disagree that market-value accounting is difficult, I think we can't avoid using it in one way or another, and I'd like to see more progress in that direction. When banks fail, the net cost to the insurance fund depends on the market value of the institution, not its book value. Therefore, to protect the insurance fund properly, we need to make some assessment of the market values of the banks it's insuring. When bank management makes decisions about its portfolio, it bases them on market values, of course, since it cares about the implications for its shareholders. If the safety net is run using different accounting, therefore, it's open to exploitation by market-oriented bankers. All the parameters of the safety net (capital levels, closure rules, insurance premiums) thus must be based on our best estimates of the market value net worth of the insured banks.

On too-big-to-fail, I am something of a hawk. I believe we have to be very sparing in making exceptions to closure policy for big banks. While a TBTF policy decreases the risk that one failure will lead to other failures, it increases the likelihood that banks will carry riskier portfolios. Our best protection against such an outcome is not forbearance by the regulator when a big failure looms. Our best protection is continuous surveillance by market participants in their day-to-day dealings with big banks. And we can best mobilize this surveillance by making it clear that even big banks are at risk.

Finally, let me offer some thoughts on expanded powers. This is a crucial part of reform for two reasons. First, the U.S. is unique in the severity of its restrictions on bank powers. It's very likely that we are paying a price for these restrictions in the form of less efficient intermediation of credit to business and industry. So I applaud the proposals to permit interstate branching. And the proposed enhancement of underwriting powers also is important--although some of the legislation has such high firewalls between banking and investment banking that I fear the synergies may be handicapped.

But I also think we should take a more extensive look at mixing banking and commerce. The Treasury proposes permitting nonbank firms to own banks, which is a subject of debate in the Congress. Frankly, I don't think this is a very important feature, since there's little obvious benefit to a firm in owning a bank. At the same time, restrictions on banks investing in the equity of commercial firms would be tightened. To me, this takes us in the wrong direction. We are alone among the 10 major banking powers in the world in the severity of the limits we place on banks owning or controlling commercial firms. And recent research suggests that these limits may harm intermediation of credit to commerce. This is because such powers appear to be important in managing lending risk, particularly involving certain types of credits. While I'm not wholly convinced, I think that when empirical evidence and theory point in the same direction, it's worth some consideration.

A second point on expanded powers: the conflict between expanded powers and concern about the safety net, I believe, has been overstated somewhat. Restricted powers probably have led to deteriorating profit and market share. This has made it harder to administer the safety net. Indeed, deteriorating net worth helps trigger the go-for-broke behavior of insured banks. In addition, success in such new activities as investment banking depends critically on reputational capital or goodwill. Therefore, such activities serve to check excessive risk-taking, since it puts reputational capital at risk. A glance at the recent events in the investment banking industry serves as a case in point. In a different way, interstate branching also provides protection for the safety net by permitting greater portfolio diversification and less exposure to single sources of risk. Letting banks have equity positions also might be helpful. As any venture capitalist will tell you, holding the equity of a borrower helps to control the risk of lending.

In summary, we don't have to give up vigor in our banking system to have stability. By implementing prompt, corrective action at high levels of capital, we'll eliminate the temptation to exploit the safety net. And by expanding the intermediation powers of highly capitalized banks, we can give them further reason to avoid problems in the first place, and an incentive to increase capital.