

For release on delivery
10 00 a m E S T
March 19, 1997

Statement by
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Chairman
Board of Governors of the Federal Reserve System
before the
Subcommittee on Capital Markets, Securities and
Government Sponsored Enterprises
of the
Committee on Banking and Financial Services
U S House of Representatives
March 19, 1997

Mr Chairman, members of the Subcommittee, thank you for inviting me to present the views of the Federal Reserve Board on the supervision of our nation's banking organizations should they be authorized by the Congress to engage in a wider range of activities. As you know, the Board has supported financial modernization for many years and hopes that the Congress will act to facilitate reforms that, by enhancing competition within the financial services industry, would benefit the consumers of financial products in the United States.

Financial modernization may well mean that future banking organizations will be sufficiently different from today as to require perhaps substantial changes in the supervisory process for the entire organization. Just how much modification may be needed will depend on the kinds of reforms the Congress adopts. In evaluating those modifications, I would like to underline the significant supervisory role required by the Federal Reserve to carry out its central bank responsibilities. I also would like briefly to discuss the continued importance of umbrella supervision and the implications of a wider role for bank subsidiaries in the modernization process.

Supervision and Central Banking

There are compelling reasons why the central bank of the United States--the Federal Reserve--should continue to be involved in the supervision of banks. The supervisory activities of the Federal Reserve, for example, have benefited from its economic stabilization responsibilities and its recognition

that safety and soundness goals for banks must be evaluated jointly with its responsibilities for the stability and growth of the economy. The Board believes that these joint responsibilities make for better supervisory and monetary policies than would result from either a supervisor divorced from economic responsibilities or a macroeconomic policymaker with no practical experience in the review of individual bank operations.

To carry out its responsibilities, the Federal Reserve has been required to develop extensive, detailed knowledge of the intricacies of the U.S., and indeed the world, financial system. That expertise is the result of dealing constantly over many decades with changing financial markets and institutions and their relationships with each other and with the economy, and from exercising supervisory responsibilities. It comes as well from ongoing interactions with central banks and financial institutions abroad. These international contacts are critical because today crises can spread more rapidly than in earlier times--in large part reflecting new technologies--and require a coordinated international response.

Crisis Management and Systemic Risk Second only to its macrostability responsibilities is the central bank's responsibility to use its authority and expertise to forestall financial crises (including systemic disturbances in the banking system) and to manage such crises once they occur. In a crisis, the Federal Reserve, to be sure, could always flood the market with liquidity

through open market operations and discount window loans, at times it has stood ready to do so, and it does not need supervisory and regulatory responsibilities to exercise that power. But while sometimes necessary in times of crises, such an approach may be costly and distortive to economic incentives and long-term growth, as well as an insufficient remedy. Supervisory and regulatory responsibilities give the Federal Reserve both the insight and the authority to use techniques that are less blunt and more precisely calibrated to the problem at hand. Such tools improve our ability to manage crises and, more importantly, to avoid them. The use of such techniques requires both the authority that comes with supervision and regulation *and* the understanding of the linkages among supervision and regulation, prudential standards, risk taking, relationships among banks and other financial market participants, and macroeconomic stability.

Our financial system--market oriented and characterized by innovation and rapid change--imparts significant benefits to our economy. But one of the consequences of such a dynamic system is that it is subject to episodes of stress. In the 1980s and early 1990s we faced a series of international debt crises, a major stock market crash, the collapse of the most important player in the junk bond market, the virtual failure of the S&L industry, and extensive losses at many banking institutions. More recently, we faced another Mexican crisis and, while in the event less disruptive, the failure of a large British

merchant bank. In such situations the Federal Reserve stands ready to provide liquidity, if necessary, and monitors continuously the condition of depository institutions to contain the secondary consequences of any problem. The objectives of the central bank in crisis management are to contain financial losses and prevent a contagious loss of confidence so that difficulties at one institution do not spread more widely to others. The focus of its concern is *not* to avoid the failure of entities that have made poor decisions or have had bad luck, but rather to see that such failures--or threats of failures--do not have broad and serious impacts on financial markets and the national, and indeed the global, economy.

The Federal Reserve's ability to respond expeditiously to any particular incident does not necessitate comprehensive information on each banking institution. But it does require that the Federal Reserve have in-depth knowledge of how institutions of various sizes and other characteristics are likely to behave, and what resources are available to them in the event of severe financial stress. Even for those events that might, but do not, precipitate financial crises, the authorities turn first to the Federal Reserve, not only because, as former Chairman Volcker noted last month, we have the money, but also because we have the expertise and the experience. We currently gain the necessary insight by having a broad sample of banks subject to our supervision and through our authority over bank holding companies.

Payment and Settlement Systems Virtually all of the U S dollar transactions made worldwide--for securities transfers, foreign exchange and other international capital flows, and for payment for goods and services--are settled in the United States banking system. A small number of transactions that comprise the vast proportion of the total value of transactions are transferred over large-dollar payment systems. Banks use two of these systems--Fedwire, operated by the Federal Reserve, and CHIPS, operated by the New York Clearing House--currently to transfer \$1.6 trillion and \$1.3 trillion a day, respectively. CHIPS settles its members' net positions on Fedwire.

These interbank transfers, for banks' own accounts and for those of their customers, occur and are settled over a network and structure that is the backbone of the U S financial system. Indeed, it is arguably the linchpin of the international system of payments that relies on the dollar as the major international currency for trade and finance. Disruptions and disturbances in the U S payment system thus can easily have global implications. Fedwire, CHIPS, and the specialized depositories and clearinghouses for securities and other financial instruments, are crucial to the integrity and stability not only of our financial markets and economy, but those of the world. Similarly, adverse developments in transfers in London, Tokyo, Singapore, and a host of other

centers could rapidly be transferred here, given the financial interrelationships among the individual trading nations

In all these payment and settlement systems, commercial banks play a central role, both as participants and providers of credit to nonbank participants. Day-in and day-out, the settlement of payment obligations and securities trades requires significant amounts of bank credit. In periods of stress, such credit demands surge just at the time when some banks are least willing or able to meet them. These demands, if unmet, could produce gridlock in payment and settlement systems, halting activity in financial markets. Indeed, it is in the cauldron of the payments and settlement systems, where decisions involving large sums must be made quickly, that all of the risks and uncertainties associated with problems at a single participant become focussed as participants seek to protect themselves from uncertainty. Better solvent than sorry, they might well decide, and refuse to honor a payment request. Observing that, others might follow suit. And that is how crises often begin.

Limiting, if not avoiding, such disruptions and ensuring the continued operation of the payment system requires broad and indepth knowledge of banking and markets, as well as detailed knowledge *and* authority with respect to the payment and settlement arrangements and their linkages to banking operations. This type of understanding and authority--as well as knowledge

about the behavior of key participants--cannot be created on an *ad hoc* basis. It requires broad and sustained involvement in both the payment infrastructure and the operation of the banking system. Supervisory authority over the major bank participants is a necessary element.

Monetary Policy While financial crises and payment systems disruptions arise only sporadically, the Federal Reserve conducts monetary policy on an ongoing basis. In this area, too, the Federal Reserve's role in supervision and regulation provides an important perspective to the policy process. Monetary policy works through financial institutions and markets to affect the economy, and depository institutions are a key element in those markets. Indeed, banks and thrifts are more important in this regard than might be suggested by a simple arithmetic calculation of their share of total credit flows. While diverse securities markets handle the lion's share of credit flows these days, banks are the backup source of liquidity to many of the securities firms and large borrowers participating in these markets. Moreover, banks at all times are the most important source of credit to most small- and intermediate-sized firms that do not have ready access to securities markets. These firms are the catalyst for U.S. economic growth and the prime source of new employment opportunities for our citizens. The Federal Reserve must make its monetary policy with a view to how banks are responding to the economic environment. This was especially important during the "credit

crunch” of 1990. Our supervisory responsibilities give us important qualitative and quantitative information that not only helps us in the design of monetary policy, but provides important feedback on how our policy stance is affecting bank actions.

The macroeconomic stabilization responsibilities of the Federal Reserve make us particularly sensitive to how regulatory and supervisory postures can influence bank behavior and hence how banks respond to monetary policy actions. For example, capital, liquidity, loan loss reserve, and asset quality evaluation policies of supervisors will directly influence the manner and speed with which monetary policy actions work. In the development of interagency rules and policies, the Federal Reserve brings to the table its unique concerns about the impact of these rules on credit availability, potential responses to changes in interest rates, and the consequences for the economy. We believe that, as a result, supervisory policy is improved.

Federal Reserve's Supervisory Role

For all of these reasons, the Board believes the Federal Reserve needs to retain a significant supervisory role in the banking system. Just exactly how that is achieved depends critically on the types of reforms the Congress enacts and the direction the banking industry takes in structuring and conducting its activities. In the Board's view, its current authority is adequate for the current structure. For today's financial system, we are able to meet our obligations by

the intelligence we gain from, and the authorities we have over the modest number of large banks we directly supervise and the holding companies of these and other large banks over which we have a direct umbrella supervisory role. Our information is importantly supplemented by our supervision of a number of other banks of all sizes, namely state member banks. Currently, the latter group gives us a good representative sample of organizations of all sizes outside the largest entities.

The large entities are essential if we are to address the Federal Reserve's crisis management and systemic risk responsibilities, deal with international financial issues involving foreign central banks, manage risk exposures in payment systems, and retain our practical knowledge and skill base in rapidly changing financial markets. Large bank holding companies are typically at the forefront in financial innovation and in developing sophisticated techniques for managing risks. It is crucial that the Federal Reserve stay informed of these events and understand directly how they work in practice. Directly supervising both these large organizations and a sample of others is also critical to our ability to conduct monetary policy by permitting us to gain first-hand on-the-spot intelligence on how changes in financial markets--including those induced by monetary policy--are affecting money and credit flows.

If in the future the holding company becomes a less clear window into the banking system, the Board believes that the Congress would need to

change the supervisory structure if the central bank is to carry out the responsibilities I have discussed today

Umbrella Supervision

The Congress, in its review of financial modernization, must consider legal entity supervision alone versus legal entity supervision supplemented by umbrella supervision. The Board believes that umbrella supervision is a realistic necessity for the protection of our financial system and to limit any misuse of the sovereign credit, that is, the government's guarantees that support the banking system through the safety net.

The bank holding company organization increasingly is being managed so as to take advantage of the synergies between its component parts in order to deliver better products to the market and higher returns to stockholders. Such synergies cannot occur if the model of the holding company is one in which the parent is just, in effect, a portfolio investor in its subsidiary. Indeed, virtually all of the large holding companies now operate as integrated units and are managed as such, especially in their management of risk.

One could argue that regulators should be interested only in the entities they regulate and, hence, review the risk evaluation process only as it relates to their regulated entity. Presumably each regulator of each entity--the bank regulators, the SEC, the state insurance and any state finance company authorities--would look only at how the risk management process affected

their units. It is our belief that this simply will not be adequate. Risks managed on a consolidated basis cannot be reviewed on an individual legal entity basis by different supervisors.

The latter logic motivated the congressional decision just five years ago to require that foreign banks could enter the United States if, and only if, they were subject to consolidated supervision. This decision, which is consistent with the international standards for consolidated supervision of banking organizations, was a good decision then. It is a good decision today, especially for those banking organizations whose disruption could cause major financial disturbances in United States and foreign markets. For foreign and for U.S. banking organizations, retreat from consolidated supervision would, the Board believes, be a significant step backward.

We have to be careful, however, that consolidated umbrella supervision does not inadvertently so hamper the decisionmaking process of banking organizations as to render them ineffectual. The Federal Reserve Board is accordingly in the process of reviewing its supervisory structure and other procedures in order to reflect a market-directed shift from conventional balance sheet auditing to evaluation of the internal risk management process. Although focussed on the key risk management processes, it would sharply reduce routine supervisory umbrella presence in holding companies. As the Committee knows, the Board has recently published for comment proposals to expedite the

applications process, and the legislation Congress enacted last year eased such procedures as well. Nonetheless, the Board requests even greater modification to its existing statutory mandate so that the required applications process could be sharply cut back, particularly in the area of nonbank financial services.

In the Board's view, those entities interested in banks are really interested in access to the safety net, since it is far easier to engage in the nonsafety net activities of banks without acquiring a bank. If an organization chooses to deliver some of its services with the aid of the sovereign credit by acquiring a bank, it should not be excused from efforts of the government to look out for the stability of the overall financial system. For bank holding companies, this implies umbrella supervision. Although that process will increasingly be designed to reduce supervisory presence and be as nonintrusive as possible, umbrella supervision should not be eliminated, but recognized for what it is: the cost of obtaining a subsidy.

Nonetheless, we would hope that should the Congress authorize wider activities for financial services holding companies that it recognize that a bank which is a minor part of such an organization (and its associated safety net) can be protected through adequate bank capital requirements and the application of Sections 23A and 23B of the Federal Reserve Act. The case is weak, in our judgment, for umbrella supervision of a holding company in which the bank is not the dominant unit and is not large enough to induce systemic problems should it fail.

Subsidiaries, Subsidies, and Safety Nets

The members of this Subcommittee are, I think, aware of the Board's concerns that the safety net constructed for banks inherently contains a subsidy, that conducting new activities in subsidiaries of banks will inadvertently extend that subsidy, and that extension of any subsidy is undesirable. The Subcommittee recently heard testimony that there is no net subsidy and, therefore, the authorization of nonbank activities in bank subsidiaries would neither inadvertently extend this undesirable side effect of the safety net nor reduce the importance of the holding company as a consequence of the increased incentives to shift activities from the holding company to the bank.

Mr. Chairman, I would like briefly to comment on these latter views.

Subsidy values--net or gross--vary from bank to bank, riskier banks clearly get a larger subsidy from the safety net than safer banks. In addition, the value of the subsidy varies over time, in good times, markets incorporate a low risk premium and when markets turn weak, financial asset holders demand to be compensated by higher yields for holding claims on riskier entities. It is at this time that subsidy values are the most noticeable. What was it worth in the late 1980s and early 1990s for a bank with a troubled loan portfolio to have deposit liabilities guaranteed by the FDIC, to be assured that it could turn illiquid to liquid assets at once through the Federal Reserve?

discount window, and to tell its customers that payment transfers would be settled on a riskless Federal Reserve Bank? For many, it was worth not basis points but percentage points. For some, it meant the difference between survival and failure.

It is argued by some that the cost of regulation exceeds the subsidy. I have no doubt that the costs of regulation are large, too large in my judgment. But no bank has turned in its charter in order to operate without the cost of banking regulation, which would require that it operate also without deposit insurance or access to the discount window or payments system. To do so would require both higher deposit costs and higher capital. Indeed, it is a measure of the size of banks' net subsidy that most nonbank financial institutions are required by the market to operate with significantly higher capital-to-asset ratios than banks. Most finance companies, for example, with credit ratings and debenture interest costs equal to banks are forced by today's market to hold six or seven percentage points higher capital-to-asset ratios than those of banks.

It is instructive that there are no private deposit insurers competing with the FDIC. For the same product offered by the FDIC, private insurers would have to charge premiums far higher than those of government insurance, and still not be able to match the certainty of payments in the event of default, the

hallmark of a government insurer backed by the sovereign credit of the United States

The Federal Reserve has a similar status with respect to the availability of the discount window and riskless final settlement during a period of national economic stress. Providing such services is out of the reach of all private institutions. The markets place substantial values on these safety net subsidies, clearly in excess of the cost of regulation. To repeat, were it otherwise, some banks would be dropping their charters if there were not a net subsidy.

In fact it is apparently the lower funding costs at banks, that benefit directly from the subsidy of the safety net, that has created the tendency for banking organizations to return to the bank and its subsidiaries many activities that are authorized to banks. These activities previously had been conducted in nonbank affiliates for reasons such as geographic and other inflexibilities, which have gradually eased. Indeed, over the last decade the share of consolidated assets of bank holding companies associated with nonbank affiliates--other than Section 20 securities affiliates--has declined almost half to just 5.2 percent. This tendency reflects the fact that asset growth that earlier had been associated with nonbank affiliates of bank holding companies--consumer and commercial finance, leasing, and mortgage banking--has most recently occurred largely in the bank or in a subsidiary of the bank. To be

sure, as Chairman Helfer indicated to the Subcommittee earlier this month, many banking organizations still retain nonbank subsidiaries. Our discussions with bank holding companies, however, suggest that in some cases, these affiliates were acquired in the past and have established names and an interstate network whose value would be reduced if subsumed within a bank. There are also often adverse tax implications for the shift. And, finally, some of these activities may not be asset intensive and hence may not benefit significantly from bank funding.

Clearly, the authorization of *new* activities in bank subsidiaries that are not now permitted either to banks or their affiliates would tend to accelerate the trend to reduce holding company activity, even if these activities were also permitted to holding company subsidiaries. The subsidy inherent in the safety net would assure that result, extending the spread of the safety net and requiring that the Federal Reserve's authority and ability to meet its responsibilities be shifted to a different paradigm.

Such a result is reason enough for our concern about the spreading of the safety net subsidy. But we should also be concerned because of the distortions subsidies bring to the financial system more generally. After all, the broad premise underlying financial modernization--with its removal of legislative and regulatory restrictions--is that free and often intense competition will create the most efficient and customer-oriented business system.

This principle has proved itself, generation by generation, with ever higher standards of living

In financial, as well as most other, markets the principle is rooted in another premise--that the interaction of private competitive forces will, with rare exceptions, create a stable error self-correcting system. This premise is very seriously called into question if government subsidies are supplied at key balancing points. By their nature, subsidies distort the establishment of competitive market prices, and create incentives that misalign private risks with private gains. Such distortions undermine the error self-correcting mechanisms that support strong financial markets.

We must be very careful that in the name of free market efficiency we do not countenance greater powers and profits subsidized directly or indirectly by government.

Conclusion

Mr. Chairman, in conclusion, the Board believes that as the Congress moves toward financial modernization the newly created structure of financial organizations should limit, in so far as possible, the real and perceived transfer of the subsidy inherent in the safety net to nonbank activities. To maintain a level playing field for all competitors, nonbank activities must be financed at market, not subsidized, rates.

The Board also believes that financial modernization should not undermine the ability and authority of the central bank of the United States to manage crises, assure an efficient and safe payment system, and conduct monetary policy. We believe all of these require that the Federal Reserve retain a significant and important role as a bank supervisor. In today's structure, we have adequate authority and coverage to meet our responsibilities. But should erosion occur, as would likely be the case if new activities are authorized in bank subsidiaries, the Congress would have to consider what changes would be required in the Board's supervisory authority to assure that it continues to be able to meet its central bank responsibilities.