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Introduction: The Modernization of Financial Services Legislation

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F. HODGE O'NEAL CORPORATE AND SECURITIES LAW SYMPOSIUM

THE MODERNIZATION OF FINANCIAL SERVICES LEGISLATION

INTRODUCTION

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It is a pleasure to be back, both at the university and in the city in which I spent so many enjoyable and interesting years. To be sure, I have noticed recently the quaint habit of the locals to talk about real topics, and it is, I must say, refreshing to hear non-Washington conversation. I must also tell you that I have learned to speak governmentese and, what's more, I am enjoying both the language and the challenges that being a member of the Federal Reserve Board brings.

Today, I would like to talk to you about something that has devoured much of my time at the Fed and has also taught me to listen more closely to the nuances of government-speak—financial modernization. The issues are real and affect all of us in our daily lives.

Financial modernization is the term used to cover legislation that would permit financial firms—banks, securities dealers, thrifts, and insurance companies—to get into each other's business. Some variants would authorize commercial firms and banking to combine as well. "Modernizing" requires the unwinding of legislation adopted in the 1930s to address real and

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imagined conflicts that were thought to have contributed to the Great Depression, or at least to have made it worse.

At the outset, we ought to understand what it is that is driving this effort. For so long, it seems, we lived in a world in which we had our checking account at a bank, our mortgage at the S&L, bought our insurance from an independent agent and our stocks from a broker. If we were lucky enough to have a little extra, we bought other assets and investments from other specialists, and hardly ever thought of breaking out of the traditional mold. But technology and globalization have irreversibly changed what had become the post-war norm. High-speed computers and constant pressure to press the envelope of regulatory limits made possible everything from money market mutual funds to derivatives; from loans once held permanently by a bank to securitization into a capital market instrument; from computer shopping for a mortgage to a higher yielding deposit at a virtual bank; from equity mutual funds from a bank or a broker to a checking account at your credit union; from a company that will lend you a mortgage to one that will do that and sell you a casket (yes, a casket manufacturer owns an S&L); and I could go on. And let's not forget all of the firms from abroad that want to lend you money or sell you assets, just as our financial institutions operate around the world doing the same. Financial markets are so interconnected now that developments in Tokyo related to the yen, or Moscow and the ruble, or Rio de Janeiro and the real are going to affect how much you pay to get a mortgage loan in St. Louis.

The framework that was essentially constructed in the 1930s seems—and is—incompatible with the world I've just described. It is a world to which we cannot return. The financial services industry is moving in the direction of expanded activities and increased competition, driven by market realities, financial innovations, technological change, and global competition. Federal banking regulators have been trying to adjust by changing rules and using loopholes, but the existing statutes limit their options and make it clear that clean and full rationalization of the structure of the U.S. financial system will require congressional action. Indeed, financial modernization is an attempt to recognize the new realities by changing the old laws. While, in the process, consumers will, it seems clear, be made better off, some institutions will be made worse off by new competition, and existing participants will be jockeying for a more favorable position. Unfortunately, that includes regulators, each of which now has a piece of the regulatory pie, and, if I may mix my metaphors, each of which is interested in protecting its turf and prerogatives.

Such issues are, however, no different from any other major economic legislation that Congress faces every day, and for which it makes choices.

Indeed, there is substantial agreement now—something that has not existed until recently—that the time has come and action must be taken. But there are some fundamental differences of approach that must be evaluated as we consider financial modernization, and that’s what the rest of my remarks will address.

Consider for a moment that, in our market economy, businesses can buy and large sell what they want, where they want. Why is it different for banks? Well, we have learned the hard way that these businesses can have a significant effect on our economy—its stability and its growth—and the wealth of the individuals that deal with them. As a result, not only have we regulated financial institutions quite a bit, we have also—in order to protect individuals and reduce the aggregate fluctuations of the economy—conveyed certain benefits on them, especially on the banks. We insure, or guarantee, some of their claims; we provide banks access to liquidity when they need it, through the discount window where they can borrow when in temporary difficulties; we provide banks access to a payments system that can transfer funds rapidly, allowing their customers instant liquidity; and we supervise them so that bank customers can feel more confident about dealing with them. Collectively, we call all of these benefits the “safety net.” Collectively they permit banks to obtain funds more cheaply than would otherwise be the case. Or put differently, an important by-product of our decisions to stabilize banks and to protect those that deal with them is that the banks receive a subsidy from the government—in this case a lower cost of funding. That fact, an unintended by-product of other economic policies, has become critical to the argument between two competing camps on how best to accomplish financial modernization.

Why is that? Well, let’s consider the more obvious impacts of the safety net per se and of its implicit subsidy.

First, the safety net, by lowering the cost of bank funding, provides a bank with a competitive advantage over other financial institutions. The banking system ends up larger than it otherwise would be and the rivals of banks find banks a little stiffer competitors than they otherwise might be. It is true that, as economists would argue, the value of the subsidy gets spread or dispersed by competition (1) to depositors, (2) to borrowers, and (3) to initial shareholders who capture the capitalized value of the subsidy. But, none of these change the fact that the subsidy makes banks stronger competitors; it “unlevels the playing field,” in governmentese. And, as I will discuss more fully in a moment, it is for this reason that policymakers should be interested in, if not trying to eliminate subsidies, at least constraining their spread.

The safety net has another significant unintended effect, beyond the subsidy and its interinstitutional competitive implications: it weakens—in some cases eliminates—the incentive for creditors of banks to be concerned

about the strength of the bank. Why should a depositor of less than \$100,000 care if the bank is creditworthy, if it will live up to its obligations? After all, the government will promptly pay off the deposit if the bank does not. Even uninsured creditors are less careful than they might be for other businesses to whom they have lent money—for that is what a deposit is, a loan to a bank—because they know the bank is supervised and has access to liquidity through the Fed. All of this means that there is less market discipline restricting the behavior of banks. Bank management thus presents what economists call, and members of Congress have adopted in their own vocabulary, a “moral hazard.” This is shorthand for the fact that bank management, being less subject to the kind of realities that others who borrow money must face, are more free to take on risk than they otherwise would be: their risk taking, at least over some pretty wide range, does not much affect the rate they have to pay to borrow money from the public. One of the implications that flow from moral hazard, therefore, is that the incentive structure is distorted: profits belong to the private sector, but a significant part of the potential losses are socialized. Put differently, there is a disconnect between the rewards from, and the costs of, taking risk.

As a result, there is a fourth impact of the safety net—beyond subsidy and competitive and risk incentive distortions—the taxpayers, that bear the cost of the potential risk, must protect themselves through the supervision and regulation of the issuer of the guaranteed deposit. No doubt we supervise and regulate banks and other financial institutions because we have learned that their failures can have disproportionately large impacts on the macro real economy. But, in addition, we supervise as a substitute for a missing or weakened form of supervision that other borrowers have—the market discipline that creditors bring to bear in their own self interest. Banks, with less market discipline, are thus supervised and regulated by government agencies in large part in order to monitor and perhaps limit the extra risk that banks can take because they have the protection of the safety net.

Supervision and regulation are not per se good things. They represent interference—there is no other word—with the market process, and as such, this stifles innovation and some desirable risk taking. We should not want to see this supervision and regulation spread because it interferes with markets and choices, and if the safety net is extended, we will extend, by necessity, supervision and regulation. In governmentese, when businesses succeed in tapping the honey pot, as sure as God made little green apples, the regulator will have to be there to protect the taxpayer.

I hope by now it is clear that the safety net creates a whole category of problems for financial modernization. The recipient institutions, banks, have a competitive advantage through the subsidy implicit in the safety net; their

risk incentives are distorted, if not corroded, by the safety net; and inefficiencies and burdens are placed on them through supervision and regulation to protect the public from both the effects and costs of excess risk taking that the safety net creates. It is, I submit, critical that we do not, at least unintentionally, in the process of financial modernization extend the safety net more broadly than exists today. To do so, I believe would expose our system to greater risk and more regulation—both steps that could well kill the goose that lays the golden egg.

How, you might well ask, can we avoid this effect if financial modernization is defined as letting financial institutions into each other's business? For, if an insurance company buys a bank or a bank buys a securities firm, is not lower cost—subsidized funds from the bank—going to get spread around? Well, yes and no and it depends.

Now that I've clarified that, let me explain just a bit further, or at least look at the options and the trade-offs.

There are three ways you can absolutely assure that the safety net does not get spread any wider. The first is to eliminate the safety net—just do away with deposit insurance, the discount window, Fedwire, and bank supervision. The second is to do away with the need to have the safety net by doing away with banks as we know them: create replacements called narrow banks, banks that, by law, hold only very safe assets making all but a rudimentary safety net redundant. The third is just to leave banks out of financial modernization: prohibit other financial institutions from acquiring a bank and prohibit banks from acquiring other financial institutions. By even raising these options I am showing my background and my limited term in the city by the Potomac because none of these are, in my judgement and the judgement of the political pros, acceptable to the body politic. They have not been, are not, and will not be on the political agenda.

Nor, as an economist and a public policymaker, am I sure that any of these options are good public policy. Narrow banking raises in my mind some very complicated issues of risk shifting that may simply cause the same problems that created our original macro stability need for the safety net to show up elsewhere. It might be nice to roll back the size of deposit insurance, if we could. It would certainly be nice to underline to uninsured depositors the risks that they take by forcing more disclosures of banks' risk positions and requiring the authorities to act at the time of failures in ways that cause these depositors to bear the cost of their miscalculation or bad luck. But, I think deposit insurance and the whole of the safety net have stood us in good stead in the macro stability area and it would be a mistake to dismantle them. Rather, it might be best to revise our supervisory and regulatory policies in ways that simulate market discipline without the side effects that we wish to avoid. This is a road we've already begun to tread. If we excluded banks

from financial modernization in order to avoid safety net and subsidy transference over a wider area, banks would simply take a smaller share of the total financial markets pie as their less protected and subsidized competitors expanded. I doubt that banks would wither away, but they would surely become less important. Other institutions would become more important lenders and more important borrowers—that is, creators of assets for the public to hold. Should we care? After all, what is important is not the return to bank stockholders or the salaries of bank managers. What *are* important is that borrowers and lenders get served cheaply and efficiently and that the financial system contributes to economic growth and stability. If banks are less important and other institutions are more important, so what?

My conclusion is that we should *not* try to leave banks out of financial modernization. As I noted earlier, such an approach is a political nonstarter that may just hold up the whole modernization process. I've also decided that it's inequitable and inefficient. Such a decision is a unilateral action to reduce the capital value of banking, and it would require a painful and costly exodus of financial capital and human expertise to other financial institutions. Perhaps most important, there is an institutional vehicle that is available that would permit banking organizations to participate in financial modernization with a *minimal* risk of transference of the safety net subsidy: the bank holding company.

As this audience well knows, a bank holding company is a corporation that owns a bank and other authorized financial businesses. To be sure, some of the safety net subsidy leaks out of the bank to its holding company affiliates: a bank holding company has cheaper financing simply because its major subsidiary is an insured bank. In addition, a bank pays dividends, earned in part with the subsidy, to the holding company parent that can be used to finance the other affiliates and a bank can lend to its affiliates. But all this leakage appears to be rather limited, with most of the subsidy contained at the bank. Dividend payments from the bank are limited by the bank's need to maintain capital by regulation and supervision, and statute caps the lending by banks to their affiliates. In the future, banks will become a smaller part of the holding company if and as financial modernization permits them to enter other businesses. Thus, I have concluded that the holding company vehicle seems to be a perfectly reasonable way to limit the safety net transference.

One may well say that, as a member of the Federal Reserve Board and as one that has admitted liking his job there, this conclusion is not unbiased. The Federal Reserve, after all, supervises *all* bank holding companies (and state member banks, which account for only about a quarter of aggregate bank assets). Thus, I can be accused of adopting a position that protects the Fed's turf. More about that in a minute, but first let's take a look at the other

structural model for bank participation in financial modernization, championed by the U.S. Treasury.

The Treasury has been the proponent of the “option” of using either the bank holding company or the bank subsidiary as the vehicle for new permissible activities. A bank could choose either for the location of its securities firm or insurance company affiliate. Such a choice reminds me of the story about the sports writer Haywood Hale Broun who was authorized by his editor to hire an assistant for \$35 or \$40 a week, and promptly gave the most promising applicant the choice between these two sums. A subsidiary is clearly the most attractive for the bank because it is the best vehicle for transferring the safety net subsidy: the capital invested in the subsidiary is totally funded by the bank and thus benefits dollar for dollar from the bank subsidy. The subsidiary option would thus be the choice *de jure* of intelligent bank management, causing all of the things that one should worry about. It would give the sub a funding cost competitive advantage vis-a-vis independent rivals and even bank holding company affiliates. It would, in addition, distort incentives for risk taking because of that direct lower cost of capital, as well as because creditors of the sub would presume parent bank assistance in times of stress, since losses at the sub fall directly on the parent bank’s capital. As long as there is a safety net, the bank subsidiary approach to financial modernization is a truly bad idea and the Federal Reserve Board strongly opposes it on the merits.

Beyond the safety net, the operating subsidiary creates significant potential conflicts among supervisors. One of the criteria for competitive equity and equal treatment among institutions is to assume, in so far as possible, equal supervisory and regulatory treatment regardless of structure or ownership—what in governmentese is called functional regulation. Reflective, I believe, of the close, intimate relationship between a bank and its subsidiary, the departments of the Treasury that regulate national banks, the Office of the Comptroller of the Currency, as well as the Office of Thrift Supervision, have already indicated their opposition to relying on and deferring to regulation of securities subs of their depository institutions by the SEC and insurance subs of these entities by the state insurance regulators. Even if these problems were addressed, it seems entirely possible that, since losses of subsidiaries are borne by their bank parent, difficulties at subs sow the seeds of conflict between the functional regulator of the sub and the regulator of the bank. Difficult issues would arise about which entity should be assisted in times of stress, as well as about the effect of any action by one regulator on the entity supervised by another. The parent of a subsidiary of a holding company is not an entity that is protected by the safety net, and the risk of these conflicts is minimized.

My colleagues and I are also concerned about the implications of the bank

subsidiary form on the safety and soundness of banks. It is not, let me hasten to add, that we think most of the proposed new financial activities are unusually risky. They are not. Rather, as I have noted, whatever the risk, it is a fact that any loss suffered by the new subsidiary must fall on the bank's capital and weaken the bank. In contrast, losses at a subsidiary of the holding company fall on the holding company's capital, not the bank's. The Treasury likes to underline how the profits of a bank sub strengthen the bank because subsidiary profits increase the bank's capital, and their accounting and arithmetic on this are impeccable. However, if there is to be a real benefit one has to assume that more can be earned on the bank's investment in the sub than it can earn in banking. It is an iron law of financial economics that the higher the return the higher the risk, and the higher the risk the higher the chance of loss—and *that* is, in fact, our concern.

The Treasury believes our concerns are unfounded because they would cap the investment in the sub to the amount of the excess *regulatory* capital of the bank and deduct that investment from the bank's *regulatory* capital. Poof, it's gone! And any bank sub losses would thus do nothing to the bank's capital because first, the deduction has already occurred and second, at the split second when sub losses equal the initial investment, the sub by rule would be declared bankrupt and any losses above that amount would be reversed when the bankruptcy is closed out. I'm not sure what the lawyers in the audience may think of that, but economists and market types have some real doubts. Excess regulatory capital is a regulator's construct. The market looks at that capital as real, as does the bank management that is holding the capital the market demands of it. Indeed, under GAAP there will be no deduction and bank creditors—like uninsured depositors—will look to that capital for protection. And, I'm sure this audience will agree, the creditors of the failed sub will meet the bank in court, trying to require private bank assumption of subsidiary debt and the reversal of any losses in excess of the original investment—which can happen in minutes intraday in today's financial markets—can well take months or years to resolve.

Full analysis requires that we step back from these increasingly technical arguments. All sides, I think, agree that we need financial reform. Both sides agree that the safety net is a problem. The disagreement is about structure and the disagreement is strongly and deeply felt. The issue of turf has been raised. The Fed supports bank holding companies as the structure, and it supervises and regulates bank holding companies. The Treasury supports the operating subsidiary of the bank—the op sub—option, and through a department of the Treasury, the Office of the Comptroller of the Currency, it supervises national banks, the class of banks most likely to take advantage of new permissible activities. What are the respective turf arguments?

The Treasury argues that in a republic the elected administration should have a significant, important voice in economic policy, including banking. This argument, by the way, is not limited to the current Administration; it has been voiced by several recent Administrations from both parties. But that position requires that the Administration's policy entry be through the national banking system, which it supervises. Indeed, in the current discussions the Treasury asserts that without its version of modernization, the national banks will decline—a curious observation since national banks' market share has risen notably with interstate banking.

I, for one, believe that the Treasury's posture on the need to be a significant policymaker in banking has merit. We should look for ways to assure that they play a significant role in banking and financial markets. But, I, for one, also think it would be a terrible mistake to do so in a way that spreads the distortions and costs of the safety net and increases the risks to the banking system.

Finally, I feel compelled to explain the need for the Federal Reserve to continue to be a significant participant in bank supervision. This role is exercised through two relationships. First, the Fed is the primary bank regulator for state member banks. I noted earlier that state member banks represent only one-fourth of total banking assets. More important, perhaps, in relation to the Fed's systemic risk responsibilities, the Fed is the primary regulator of only seven of the largest twenty-five banking organizations. Therefore, the primary window through which the Fed maintains contact with, and oversight of, the largest and most complex banking organizations is as supervisor of bank holding companies. The latter role, I might add, would decline significantly if the op sub, the banking subsidiary, approach were adopted. The economics of the safety net subsidy simply would induce a massive shift from bank holding companies to bank subsidiaries, leaving the holding company an unneeded husk in relatively short order. Why should we care? Or why should anyone not an employee of the Fed care?

The Federal Reserve, in its role as the central bank of the United States, is the institution that is charged not only with monetary policy and contributing to macro economic stability, but also to avoiding and managing financial crises. I believe that responsibility requires that we have the authority to act and that our staff maintain the expertise about how the system really works that simply cannot be obtained from reading reports from another agency or even textbooks from scholars at Washington University. That expertise, I believe, comes only from hands on knowledge of banking and financial institutions and markets that can come only from supervision. If our supervisory responsibility begins to atrophy, so will our skills. A central bank with ivory tower knowledge will not be able to deal adequately with financial crises.