Financial Services in the Year 2000

"While the expansion of banking powers is consistent with a flexible, safe, and efficient financial system and increased real benefits to consumers, there still remain reasons for policy makers to be cautious about such changes in financial structure," said Alan Greenspan, Chairman of the Federal Reserve Board and keynote speaker at the 24th annual Conference on Bank Structure and Competition, sponsored by the Federal Reserve Bank of Chicago on May 12-13, 1988. The Conference offered many experts from regulatory agencies, the banking industry, and academia the opportunity to present their views and recommendations for balancing the benefits of increased efficiency from expanded powers against possible increases in bank risk.

In a number of speeches and panel discussions, the participants discussed a variety of issues, including the effects of October 19, financial restructuring, corporate separateness, new powers, and bank risk. The last session of the Conference assembled a panel of industry experts who attempted to sum up the two days of discussion and build a framework for restructuring. The panel included Donald Crawford, senior vice president and director of government relations for the Securities Industry Association; Robert Litan, senior fellow at the Brookings Institution; S. Waite Rawls III, vice chairman of Continental Illinois Corporation; and Kenneth Scott, professor of law at the Stanford Law School.

New powers

While many at the Conference believed that banking firms would be granted broader powers, there was considerable disagreement about the specific powers banking firms would and should have.

Kenneth Scott, of the Stanford Law School, provided some insight into the determination of new bank powers. According to Mr. Scott, if new bank powers are determined in the political arena where special interest groups need a "super majority" to effect change but a simple majority to keep the status quo, little change will occur. If new powers for banking firms are left to the regulators, only those powers that are easily understood or easily measured will be granted. If new powers are decided by economists, new powers will be granted only if there are synergies between banking and the new activities. Finally, said Mr. Scott, if new powers are determined by the market, those firms that correctly assess the opportunities for expansion will be rewarded and those that do not will be punished. This "marketplace calculus," according to Mr. Scott, is the best way from an efficiency standpoint to determine which new powers are appropriate for banking firms.

Donald Crawford, from the Securities Industry Association, argued that the politcal process, in fact, was directing the push for new powers in an inappropriate direction—toward securities activities. Citing profitability figures for the underwriting of various securities, Mr. Crawford argued that competition, tax reform, and deregulation have narrowed spreads in virtually every area of investment banking. Therefore, if banks entered this industry, the competition would be ruinous to both banking firms and securities firms. "Combining the two industries will exponentially increase the potential for mismanagement on both sides of the fence," said Mr. Crawford. Earlier in the day, William T. Gregor, a senior vice president at the MAC Group, had made the same point: "For many banks underwriting is going to be an economic Vietnam."

Furthermore, Mr. Crawford noted that the securities industry is one in which "mistakes are made easily," and is "unforgiving" because assets are marked to market daily. To support this contention he pointed to the Stock Market Crash of October 1987. As a result of the Crash, the securities industry lost $2.2 billion in two days, $1.7 billion of which was from trading accounts. This produced the worst quarter in the history of the securities industry. "You can't underwrite unless you make markets," Mr. Crawford warned the bankers in the audience, "and if you make markets, you will occasionally have to take hits."

These losses, however, did not impress S. Waite Rawls III, Continental Illinois Corporation and the only commercial banker on the panel: "Shoot, a billion seven. Citi[bank] charged off twice that in a day. I thought we were talking about risk here." Mr. Rawls also asked Mr. Crawford, "If what you're protecting is worth so little, why do you defend it so doggedly?"

In a previous session of the Conference, Larry Mote, a vice president and economic adviser at the Federal Reserve Bank of Chicago, may have provided an answer to Mr. Rawls' question. He noted that average returns and levels of compensation in the securities industry are relatively high. Moreover, there is a high degree of concentration and barriers to entry are significant in the securities industry. These characteristics, along with long-run stability of some spreads, are suggestive of market power.

In his presentation, Robert Litan, of the Brookings Institution, suggested that if banks broaden their securities activities, prices for underwriting services are going to come down and profits will decrease. This effect will be most pronounced in merger and acquisition services, according to Mr. Litan. Currently, banks can provide advice on mergers and acquisition, but cannot underwrite corporate securities. However, underwiting capabilities are very advantageous to the M&A business. Earlier, Thomas G. Labrecque, president and chief operating officer of Chase Manhattan Corporation, had commented on that very issue. He stated that his organization recently lost business to Deutsche Bank because Chase cannot underwrite corporate securities. "In my humble opinion," Mr. Litan opined, "those fat, outrageous M&A fees would come down if banks were in that business and could also underwrite securities."

Robert Litan, however, conceded to Mr. Crawford that securities may not be the most important area for banking firms to enter. Mr. Litan felt that bank entry into insurance would have a greater impact on consumers than bank entry into the securities industry. Citing studies of the Consumers Federation of America and the American Insurance Association, Mr. Litan estimated that more competition in insurance agency would reduce premiums by $5 billion annually. Banking, he argued, is a logical source for this new competition. As John Boyd, a research officer at the Federal Reserve Bank of Minneapolis, contended earlier in the day, life insurance underwriting is a low-risk activity, and if banking firms were to engage in this activity, their overall level of risk would likely decrease.

Restructuring

If banks are going to be granted broader powers—securities as well as real estate and insurance—how should the financial services industry be restructured so that safety and soundness are preserved; the safety net is not extended to nonbank sectors; and efficiency is not sacrificed? In other words, restructuring requires walking a tight rope between risk and efficiency.

"In this industry [banking]," said Mr. Rawls, "risk is a four-letter word," but without risk, a company would have "zero potential for revenues or growth." Mr. Rawls continued, "Today, risk is adapting to a new reality, or failing to adapt." That new reality is that "the needs of business have changed faster than banks' capability of serving those needs. Being a reliable provider of funds just isn't enough anymore." Earlier in the day, Bert Ely, a financial institutions consultant, had stated that the financial services industry is changing more rapidly than banking regulation, due to electronic technology and financial innovation. The issue, said Mr. Rawls, "is what are we going to do about it?"

Three conference participants, Robert Litan, Robert Laurence of the Federal Financial Institutions Examination Council, and Samuel Talley, a banking consultant, would allow a banking firm to engage in any nonbank activity it chooses so long as those activities are carried out in subsidiaries of the holding company and the banking subsidiaries are "narrow banks." A narrow bank is one that accepts deposits and invests them only in government securities.

Mr. Litan conceded that having nonbank activities operated as a bank subsidiary would be more efficient, but it would also be riskier. In other words, the temptation for the bank to come to the rescue of a nonbank subsidiary would be great since the performance of the subsidiary directly affects the bank's financial statements. Therefore, in the interest of safety, Mr. Litan said that he preferred that nonbank activities be carried out by subsidiaries of the bank holding company rather than the bank.

Locating nonbank operations in subsidiaries of the holding company, however, was not enough for Mr. Litan, nor was it enough for the other panelists. All agreed that "firewalls" are needed. How high, how thick, and of what substance, however, were major issues yet to be resolved.

According to Mr. Litan, the choices are imperfect. One of those choices is the "lawyers/regulators approach." This approach entails making rules and regulations that govern transactions and affiliations between banks and their nonbank affiliates.

Mr. Rawls thought that this "approach" was not so much a means to control risk but a battle over turf. The Glass Steagall Act separated investment and commercial banking, but "the insidious thing is," explained Mr. Rawls, "it also created separate regulatory bodies—the SEC and the Fed. And it created separate Congressional committees to oversee the separate regulatory bodies." The problem, according to Mr. Rawls, is that "the distinction between banking and securities has really blurred; the distinctions between the bodies that regulate them have not." Consequently, "the issues are discussed from two different points of view. Compromise is hard to come by. Firewalls, functional regulation, and subsidiaries are products to serve the regulators and Congress, not to serve bankers or their customers," said Mr. Rawls.

Mr. Rawls as well as the other panelists felt it necessary to distinguish between financial firewalls and management and marketing firewalls. While Mr. Crawford was accused of favoring management and marketing firewalls, such as a ban on cross marketing, the other panelists generally agreed that only financial firewalls were appropriate and necessary. As Mr. Rawls pointed out, "you have to keep bank deposits away from other activities, but not marketing and management." In fact, he argued that marketing and management firewalls would increase risk and reduce efficiency. Furthermore, as for financial firewalls, Mr. Rawls said that if barriers are erected, deposits should not necessarily be with loans on one side of the firewall and securities on the other side.

That solution flies in the face the "narrow bank" proposal. The narrow bank proposal is another firewall alternative and the one that Mr. Litan believes to be the best among the imperfect choices.

Because a narrow bank does not make loans, all lending as well as other activities would be carried out in nonbank affiliates under the umbrella of a bank holding company. According to Mr. Litan's proposal, bank holding companies that converted their banks to narrow banks could engage in any nonbank activities, not only those deemed permissible by the regulators or Congress. The deposits of narrow banks would be federally insured, but they would have relatively low deposit insurance premiums because they are virtually risk-free entities. Narrow banks could invest in both long- and short-term government securities. Conversion to narrow banking would be purely voluntary and gradual (over a ten-year period), and small banks would be exempt because, in Mr. Litan's opinion, small banks do not pose a risk to the system.

Referring to his narrow bank proposal, Mr. Litan said "I think it solves all the problems, or most of the problems that have been leveled against the banking industry in terms of going out to broader powers." He then elaborated on that point, "It solves the conflict problem because a narrow bank can't loan; it solves the run problem because a narrow bank is liquid . . . ."

Whether firewalls be in the form of rules or narrow banking, Mr. Scott questioned whether any firewalls would be effective as long as the fundamentals of the current federal deposit insurance system go unchanged. Firewalls are supposed to protect against "unacceptable risk." But protect whom? The insurance fund, said Mr. Scott, and accordingly any discussion about new powers and risk must include a discussion about federal deposit insurance. The current flat-rate system inherently has a "perverse incentive system," said Mr. Scott. Furthermore, he said that if regulation and supervision were adequate, then the current deposit system would not be in the poor condition that it currently is in. Therefore, said Mr. Scott, "if the present system is going to be bailed out but not otherwise materially altered," then the thickness of firewalls and distinctions between banking and nonbank subsidiaries becomes important. But Mr. Scott conceded, "maybe that's all that is politically possible now."

Politically possible

Other panelists at the Conference's last session also spoke of the politically possible. They all seemed to have agreed that the Congress will grant banks broader securities powers. If they don't, commented Mr. Litan, the "states will take it upon themselves to broaden securities powers," especially New York. Mr. Crawford further pointed out, and Mr. Litan concurred, that political forces may have banks trade insurance and real estate powers for securities powers. "Is the trade-off worth it?" Mr. Crawford queried.

All the panelists seemed to have agreed that the approach to firewalls would be rules-oriented. While this is not the best alternative as far as Mr. Litan was concerned, he conceded that he would not see his narrow bank proposal adopted in his lifetime. Referring to the regulatory approach to firewalls, he said that this seems to be "the direction we're headed." Mr. Rawls lamented that this approach may very well mean that when all is said and done the restrictions placed on banks' securities activities will be onerous. Then bankers will say to Congress, "thanks, but you didn't do anything."

—Christine A. Pavel