Changes in the financial markets have blurred the distinctions between banks and other depository institutions, and between depository institutions and other financial businesses.

In the midst of the blur, calls for reform have been coming from all corners, including financial institutions, regulators, the Administration and Congress, and the general public. The consensus is that reform is needed, but consensus ends there. Banks want to go into other businesses. Other businesses want to enter the banking business. Consumers want better services at lower costs. Regulators are concerned about increasing risks.

I think that it is time to step back from the details of the immediate debate, and ask some basic questions about financial market performance and the desirability of reform. (1) Why is our financial system changing? (2) Why are we so concerned about changes in our banking structure? And lastly, (3) what are the options open to us in managing the evolution of the financial system?

Why is Our Financial System Changing?
We all know that our financial system is undergoing dramatic change. Banks have been moving into new activities. Some are offering brokerage services, some are selling insurance, and others are leasing airplanes, to name a few examples. Banks are moving into new geographic areas, sometimes because state legislatures are opening their doors for out-of-state entrants; sometimes by buying troubled banks or thrift institutions as part of an emergency rescue program; sometimes by exploiting regulatory loopholes that allow entry to another state on a limited-service basis—such as offering consumer loans across state lines. At the same time, other types of businesses, such as insurance companies, investment houses, mutual savings banks, savings and loan associations (S&Ls), and the finance company affiliates of major manufacturing companies and retail store chains, continue to enter fields traditionally identified only with commercial banks.

The traditional and still-operative legal definition of a commercial bank is quite clear: any entity both offering demand deposits and making commercial loans. Today, however, we have firms that offer only one or the other. They look like banks, but don’t fall within the legal definition. These firms are referred to as nonbank banks. For example, Sears, Roebuck and Co. offers consumers deposit accounts, as does Merrill Lynch & Co., Inc. Other firms buy loans from banks, leaving the banks with the reduced role of originating and servicing loans. Consequently, some providers of financial services are regulated as banks and others are not. Moreover, even among the regulated firms, the incidence, effectiveness, and costs of regulation are uneven.

What accounts for this evolution? Quantum advances in telecommunications and computer technology now permit the rapid and low-cost transfer of funds and information worldwide. Partly in response to these opportunities, existing laws and regulations have been reinterpreted by regulators, legislators, and the courts. The resulting changes reflect a growing belief among some people that more efficiency can be achieved in the financial system with little cost to safety, soundness, and financial stability. Whether this is true or not and what the political and regulatory response should and would be to the issues of safety and soundness are, of course, the great unanswered questions underlying the current debate.

A dramatic change in the economic climate has provided an additional challenge for both financial institutions and regulators. The successful shift away from the inflationary environment during the period from the mid-1960s until the early 1980s has adversely affected some sectors of the economy, including agriculture, real estate, and energy, as well as debtor nations. Lenders with large exposures in these sectors are now paying the price for overexposure to borrowers who bet on continuing
commercial bank failures since the institutions are, as one would expect, financial services industry have con-

...and product innovation in banking and ties arising from technological advances in the system? Herein lies the crux of the approach to restructuring financial long-term problems. Furthermore, the traditional tools that we holders of the safety net—the federal deposit insurers, the Federal Reserve, and the Office of the Comptroller of the Currency—must be asked: What kind of bank structure do we really want? There should be asking is: What kind of banking structure we adopt. A decision to muddle through under the present system also ignores the un-

...ing structure as it was last revised in the 1930s. This could be done principally by closing the nonbank bank loop-

...ought to exist to serve the general public. deposit-taking institutions and whole-

...prohibitions effectively separated commercial lending and investment from retail commercial lending and investment banking institutions, neither class of which bears the regulatory costs of banking because, strictly speaking, neither constitutes a class of banks. If Congress were to give a clear and un-

...for a while. An extreme version of this approach would be to question whether some other changes in banking struc-

...of bank supervisory agencies was not a mistake. We have changed some outmoded restraints on banking when a particularly acute problem needed resolution. On those occasions, almost everyone involved, including the regulators, was surprised, but without conformance to a grand design. It was given easy—if we may be lost just as easily in the next round of banking legislation.

...which may be regretted at a later date. Without considering these principles, we will be making a de facto decision that may be regretted at a later date. I believe that the chances we may shoul...

...recent experience, however, sug-

...growth during the Depression and successfully promoted adoption of Title II of the Bank Act of 1933, which expanded the authority of the Federal Deposit Insurance Corporation. Chairman of the Board of Directors of the Recon-

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up of the present fortress would, of course, be challenged widely, especially by the more entrepreneurial sectors of the banking industry and by nonbanking enterprises that have entered banking markets. If this course were our choice, we regulators would need a clear mandate from Congress to bolster our chances of prevailing in the courts.

In its favor, this scenario does have the virtue of consistency with a fair amount of United States financial history and regulatory tradition. Working against it, however, is the thrust of our present general value structure, which seems to favor efficiency goals over those of safety, soundness, and stability. In my travels, I hear no politically effective voices speaking up in defense of this old order. After all, this may well be an approach that, as I mentioned earlier, has already been so completely undermined by the press of events and recent decisions as to be beyond repair.

**Third Scenario:**
It is possible to undertake a reform of the banking structure that would be somewhat comprehensive, unlike the piecemeal approach, yet that would not amount to turning back the clock. Congress would have to enact legislation that would affirm our longstanding belief that banking is special and, further, that would delineate more clearly the separation between commercial banking and a few other economic activities. Even if commercial banking is special, any new delineations of its boundaries probably would have to encompass powers beyond those possessed by banks today. Also, any such delineation would probably have to reduce the powers of new nonbank entrants into the financial marketplace, or at least subject these firms to a regulatory and/or supervisory constraint more comparable to those placed on banks today. Preferably, the new lines of separation would be drawn and accompanied by a statement of political intent that would guide future regulatory and court decisions implementing the new rules. This approach could entail the following features:

- A new definition of banking would be prepared, closing the nonbank bank loophole by redefining banking to include all entities engaged in taking retail deposits that are subject to withdrawal by (1) check or other draft payable to third parties, possibly including money market mutual funds; or (2) debit card or other electronic method of transfer. Congress would have to specify clearly which types of organizations could own or control banks.

- Banking powers would be broadened to include such activities as real estate and insurance brokerage; underwriting of municipal revenue bonds, commercial paper, and mortgage-backed securities; and offering investment advice to institutional customers.

- Minimum capital and risk-adjusted capital requirements would be strengthened to the extent required to cover risks associated with nonbanking ventures.

- Risk-adjusted deposit insurance premiums would be considered, either separately or in conjunction with reductions in federal deposit insurance limits, to levels that essentially protect retail depositors but not wholesale or institutional depositors.

- Access to the lender of last resort would be limited, as at present, to the provision of necessary liquidity to depository institutions on the security of sound assets.

The debate that would accompany enactment of this scenario would answer the basic questions and provide direction for the evolution now going on in the financial service markets. We would have a framework for evaluating the trade-offs between public benefits of efficiency in financial markets on the one hand, and safety and soundness on the other. Federal Reserve Chairman Paul Volcker essentially called for just such a reexamination of our objectives and procedures in his testimony before a subcommittee of the House of Representatives on June 11, 1986.

**Fourth Scenario:**
A strong move toward a rigorous, direct free-market approach to reform of the banking structure is another possibility. Our society could choose more clearly in favor of market-oriented efficiency, explicitly recognizing the possible consequences of de-emphasizing safety and soundness in the provision of financial services. For example, in his recent book, *Risk and Other Four-Letter Words*, Walter Wriston, former chairman of Citicorp, notes explicitly that no bank should be considered too large to be allowed to fail. To paraphrase Mr. Wriston, those banks or bank holding companies seeking greater returns must be prepared to assume greater risks of failure. Acceptance of that risk of failure is the price paid by market participants for the right to engage in a greatly expanded scope of activities that carry with them potentially increased risks of failure.

Within this scenario, and within the greater context of United States history, some degree of separation between banking and other lines of commerce may still be desirable and inevitable, while leaving much more room for innovation. A free-market approach could include the following elements:

- **Free Entry**
  There would be free entry into the "deposit-taking banking system." Nonbank banks, such as Sears, Roebuck and Co., could remain in the banking industry, but would be subject to compliance with applicable bank examination and bank holding company inspection requirements, including inspection at the parent company level. There would be no federal barriers to interstate provision of financial services, but the states might continue to erect barriers. Federal barriers to entry into particular states would be eliminated unless potential entrants refused to provide the information required by state or other relevant bank supervisory authorities.
tional confidence of depositors and/or share-
capital would have to be reduced
depository institutions.

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