# Perspectives on Financial Restructuring

Remarks By
L. William Seidman
Chairman
Federal Deposit Insurance Corporation

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As my friend, Henry Kissinger, used to say in staff meetings, when discussing economics, "It is with an unaccustomed sense of humility that I address you on this subject."

This distinguished group of scholars and practitioners, all pros on the subject of financial restructuring, requires me to approach the subject in the same way. While my background gave me a certain familiarity with theworkings of the financial system, not the least of which was trying to meet my borrowing commitments. I must admit restructuring of the system was not a primary concern of the past. That changes dramatically as I began to work my new job at the FDIC

My colleague in the Ford administration, former Treasury Secretary Simon, early on observed that most regulators and legislators approached the subject of banking law reforms as though they were trying to reenact the old fable about the blind men and the elephant.

After due consideration, his perception changed. He decided that an elephant was by far too clean, noble, benign, and, above all, petite, to accurately, or humanely, compare with the body of banking regulations. When he made the comparison in later years, he felt he had to swap a brontosaurus for the elephant to get things in proper scale.

Of course my comments are to be about perspective, and perspective, or the lack of it, is what the old fable is about.

I would guess that with all the expertise gathered in this room, most of you entered with a fairly fixed perspective on the future of financial institutions.

We probably each have a firm hold of some part of the animal we call the financial structure, and a firm conviction of what the whole thing really should look like. It is my modest hope that we of the FDIC can make a contribution to your thinking about the subject of financial restructuring.

For a considerable period the FDIC has been at work on a project that, we hope, you will find useful.

Although this project contains some conclusions, our aim has been NOT to come down from the mountain with a set of tablets engraved with THE restructuring proposal.

Instead, our purpose has been to assemble historical, factual information which can be useful as a starting point on the road to our future financial marketplace.

The FDIC's "Financial Restructuring Study," copies of which are available for you, we hope will help us all to reason together. Your comments, civil or otherwise, are solicited.

Bankers, businessmen, regulators, and lawmakers have all, from their varied perspectives, been aware of problems growing in the structure of our financial system for a long time.

But often, entrenched economic power, diverse views of history, and differences in regulatory philosophy, have prevented the agreement essential for a comprehensive approach to creating a new structure.

The recent banking bill passed by Congress is a case in point.

To many of us, this legislation, while containing much of benefit, still contains many more temporary fixes, moratoria, and stopgaps, than is good for the system.

As we know, a journey of a thousand miles begins with a single step. But before that step can be taken, it helps to know in what direction we wish to proceed.

Everyone seems eager to start this journey, but this legislation reflects a certain lack of unity, to say the least, with respect to an agreed general sense of direction for the financial system.

But as Henry Ford observed; "Don't find fault. Find a remedy." With this in mind, let me provide you with a little background on just how this latest FDIC study came about, along with an idea both of its scope, and of some of its findings

When I was confirmed as Chairman of the FDIC some twenty months ago, I had one advantage. As a necommer I didn't have any fixed perspective on financial restructuring.

It seemed useful to try to get together an organized and objective inventory of just what was on the table. And find out what tools were available, drawing both from historical mandates and current options.

Let me summarize then, our FDIC study.

The initial chapter gives the background which I have just covered. Chapter Two deals with the changing marketplace and concludes that market developments have slowly but significantly altered banking's traditional role, effectively weakening it, diminishing its role in the economy, and reducing its capital and its marginal safety.

The Third Chapter is an historical overview, and it examines banking in an historical perspective. It concludes that regulation of American banking institutions is involved in long and rather uneven cycles swinging back and forth like a pendulum, swinging from strict control, to comparative freedom.

As Professor Robert Higgs points out in his new book, "Crisis and The Leviathan," crisis tends to increase the growth of government control. When the crisis abates, the government loses some of its powers--but never all that it gained. This seems to apply to banking.

So at one extreme of the pendulum's arc, we see eras where the banking laws tend to leave the marketplace pretty much alone. Commerce and banking, for instance, are often intertwined. At the other extreme, we have periods of heavy government oversight and regulation, and, to use the example again, relations between commerce and banking are carefully controlled.

But overall the swings of the pendulum are not often evenly balanced, and the long term trend, as Professor Higgs points out, is an increase in government control of the marketplace.

Thus, U.S. history mandates no set program. We've tried just about everything. When our laws are changed, they are most often changed in reaction to conditions that, starting as problems, have ripened into crises. This is why we seem to swing between extremes -- from comparative freedom to strict control.

Thus our study, not surprisingly, finds no inherent historical basis for stating that finance and commerce must be separate.

The study then proceeds to deal with the Glass-Steagall Act.

It concludes that in the 1930s the general view of Congress was that the mixing of commercial and investment banking threatened the safety and soundness of the banking system, created numerous conflict of interest situations and led to economic instability. To alleviate these concerns the Glass-Steagall Act was enacted.

It appears that, to the extent that these concerns were valid, they could have been handled through a less disruptive means. But abuses did occur. The study concludes that with a degree of supervision and regulation, some restrictions on banking affiliated powers, significant progress could have been made to correct the failures that occurred without the stringent measures of Glass-Steagall. Glass-Steagall was not the required answer.

Chapter Five of the study examines the conflict of interest question in the banking system, and its potential for trouble.

It states that after an analysis of several types of potential conflicts, that in every instance it appears the level of abuse could be brought well within acceptable boundaries without resorting to the ultimate safeguards outright prohibition against the combination of two types of activity.

Now we come to Chapter Six which is the heart of the study and deals with "Safety and Soundness."

This key section discusses the ability of bank supervisors to build an effective supervisory wall around the bank, no matter who owns it.

The answer seems to be central to arguments about mixing banking and commerce.

It defines the question, "Can we create a wall around banks that makes them safe and sound, even from their owners?"

Some have argued this violates human nature and common sense Still most regulations are designed to control poor human behavior.

If a "wall" can be built direct regulatory or supervisory authority over nonbanking affiliates or even bank owners is not necessary.

This is a question that has long puzzled and fascinated economic theorists and lawmakers, the generals and aides who rule the battlefield of banking law.

But I thought it might be a good idea to consult some foot soldiers on the question -- the FDIC's corps of bank supervisors -- to get some practical opinions in addition to the theoretical ones already on hand in great supply.

Because if such a wall can be built it would seem the first step toward solving a great many questions regarding financial restructuring of banks.

The FDIC's corps of professional bank supervisory personnel, speaking from experience gained in thousands of bank examinations over a 54 year period, is that a "wall" is indeed "do-able."

Furthermore, this "wall" could be constructed in a simple, practical, and effective way. Also, it should be possible to determine what activities can occur either outside or inside the wall.

The keystone of this wall lies in appropriate bank safety supervision.

I believe it is a fact of human behavior, (at least in the U.S.), that a majority of people play by the rules. However, a small percentage usually do not. Thus, the supervisory challenge in creating a "safety and soundness" wall is to identify and restrain the minority who will abuse the system.

If, to greatly simplify with an example, 90 percent of bankers obey the law, and 10 percent seek to beat it, then the clear supervisory challenge is to see that as few as possible of the errant 10 percent succeed.

We asked our professional supervisory staff if they could create a wall, and if they could, what tools they would need.

Their answer was that most of the materials needed are already at hand.

We at the FDIC are even close to having the manpower we would need to do our part of a creation of the wall.

Currently, we have about 2,000 examiners and my staff tells me we could get our part of the job done with fewer than 2,500.

The requirements of the staff with regard to the inventory of regulatory powers is set forth in Chapter Eight. They are as follows:

First, retain the limitations on dealing with non-bank affiliates contained in Section 23A of the Federal Reserve Act. These would also need expansion to cover "nonbanking" subsidiaries of banks.

Second, retain the new Section 23B just passed by Congress, which specifies that all transactions with affiliates be conducted at an "arm's length" distance. This section also prohibits any action which would suggest the bank is responsible for any action of the non-bank affiliate.

Third, enhance authority to audit both sides of any transaction between the bank and its subsidiaries or affiliates.

Fourth, authorize collection of certain financial data from bank affiliates, if needed.

Fifth, clearly defined regulatory authority to require, from either a practical or risk standpoint, that any nonbanking activity be housed outside the bank, in either a subsidiary or affiliate. Moreover, the power is needed to exclude from the bank's supervisory capital computation any equity investments and such nonbanking businesses.

FDIC's bank supervisors, speaking from 54 years of examination experience, believe that these materials will be sufficient to construct a workable "wall."

The view of our supervisors, is that out of the TEN percent of bankers who, IN THEORY, MIGHT be prone to abuse the new rules, that these tools would be enough to catch at least nine out of ten of the abusers.

It would also mean for the vast majority of bankers a better shot than they have now for improving their competitive positions, and as well as the capital, and safety, of their institutions.

If a "wall" is possible, where do we go next?

I can tell you what my staff thinks.

They would eliminate both the Glass-Steagall restrictions, as well as much of the Bank Holding Company Act. My staff takes the position that, given proper insulation of the bank, that laws that require a holding company structure are redundant, and therefore, inefficient and unnecessary.

Some say we should do this IMMEDIATELY. They make many persuasive points. But I personally don't think I would advocate racing down that road just yet. I've sat through too many meetings with my good friend, Paul Volcker.

I concur with Winston Churchill that "Honest criticism is hard to take; particularly from a relative, a friend, an acquaintance, or a stranger." So I believe that we need to be ready to discuss the proposals in detail before we act.

My reasons for this are simple. One lesson my historical perspective pointed out is that our present financial marketplace is both more complex, and moving at higher velocity, than in any era before.

To me, this means charting a middle course that combines moving toward a relaxation of restraints on bank powers, ownership, and affiliates, while strengthening safety and soundness through supervision.

The process of deregulating an industry that has been heavily, and complexly, regulated for decades is not an easy one. No one can say NOW for sure where the course may have danger spots. But if the perspectives shown by FDIC research indicate that indeed, our course is passable, it is clearly a way to a better capitalized and more competitive banking system.

As General Patton pointed out, "Take calculated risks. That is quite different from being rash."

We don't need to set our course in stone. We can move in a step by step process toward a less regulated structure, with an evaluation of each step along the way. The suggested step-by-step process is outlined in Chapter Ten of the FDIC study.

However, if we can agree upon the fundamentals, we will know where our steps are leading us. We are headed toward a system that keeps banks safe because they are special but lets the marketplace around them operate with freedom from bank regulators.

This can create a safer and sounder system for depositors, users of the transfer system, borrowers and traders; a more competitive and better capitalized banking system, a simpler and less costly regulatory structure, and a system that can serve consumers more efficiently while assuring the Fed has its needed tools for monetary control.

As a member of the Washington bureaucracy, I am not unaware of the amount of agency turf that could be torn up by means of this restructuring--including the turf of the FDIC.

Only a agreement of the private sector on these goals can move that big and mountainous bureaucratic line defending the status quo.

As my old football coach used to tell me, to give us perspective, "The bigger they are, the harder they fall."