Remarks by

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**<u>"TOO BIG" - REVISITED</u>**

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Good afternoon, ladies and gentlemen. It's a pleasure to be with you in Atlanta today.

This is a pretty good time to think about some needed changes in our financial industry. First, because we need to prevent the kind of financial melee we have witnessed over the last few years. And second, because we need to make the industry more competitive in light of the restructuring of the European banking system in 1992.

A good beginning would be a discussion of the so-called "Too big to fail" policy in the U.S. banking system. Then I'll a look at some proposals that could replace "too big to fail" with "too strong to fail."

The extent to which the United States stands behind its largest banks is an issue closely followed by investors and banks around the world.

You know, the "too big to fail" idea became an issue back in the 1970's--but not in a banking context.

I'm referring to Lockheed Aircraft, the Chrysler Corporation, and the City of New York. For better or for worse, public officials decided that these very visible entities could not be handled effectively under the usual bankruptcy laws.

The federal government evolved a number of informal criteria for bailouts in such cases. All of these criteria had to do with the effects on the general economy from a massive default.

The "too big to fail" question became a visible <u>banking</u> issue in 1984, when the FDIC arranged an open-bank assistance package for Continental Illinois. At the time, the Comptroller of the Currency testified before Congress that certain banks <u>did</u> fall within the same "too big to fail" criteria as Lockheed and Chrysler.

<u>All</u> deposits and other liabilities of Continental Illinois' banks were protected against loss by the FDIC, as were the holding company creditors. The bank's senior management and common shareholders, of course, received no such protection. In the end, they lost their jobs and their investment.

So -- "too big" doesn't apply to owners and managers. "Too big" really applies to depositors and general creditors of the bank. And now it doesn't apply to bank holding companies as was shown in the case of First Republic of Texas.

Actually, the best moniker for this policy should be---"Too big to let depositors lose, but never too big to let stockholders and management fail." Since that's a bit awkward--let's just call it the "too big" doctrine.

Although there were several FDIC-assisted transaction before Continental that raised the same issues, the size of Continental brought the "too big" dilemma to the forefront of public debate. The controversy continues to the present day.

There are good arguments to be made both for and against the wisdom of having an implicit "too big" policy. Theoretically, there should be consistency in the treatment of all banks. The banking system should be able to operate under a defined set of rules--even if those rules mean losses to creditors if an institution should fail.

On the other hand, banks do perform functions that are not duplicated by any other single type of institution. It may be necessary to protect certain creditors of larger institutions to avoid destabilizing the overall system.

All of us who are patrons and advocates of the free market system would be happier with an approach in which the marketplace itself was free to both reward and punish. We don't like reliance on regulatory or legislative safeguards. So why do we have a "too big" policy, or for that matter why have financial safety-nets at all.

The historic rationale for these safeguards is the understandable desire to protect small and unsophisticated investors and depositors.

However, the more compelling rationale is the concern about systemic risk--that's the danger that a disruption in one part of the banking and financial system will spread to other parts of the system--undermining confidence and damaging the over-all economy.

In The Wealth of Nations, Adam Smith advocated the regulation of banking on the grounds of systemic risk. Public confidence and systemic risk are the twin pillars which support the concept of financial safety nets in all nations.

Unfortunately, and perhaps unavoidably, the existence of financial safety nets gives rise to the so-called "moral hazard" problem.

The moral hazard problem may be defined as the increased risk-taking behavior of institutions and depositors when Uncle Sam is available to come to the rescue.

Systemic risk also is not an imaginary concern. And I believe the availability of some safety net arrangement is prudent.

And, given the present structure of our banking system, we may be stuck with some kind of "too big" doctrine as well. Let me explain.

Today we have a global financial system. If the United States were to become the only industrialized nation to allow depositors and creditors of a major bank to suffer loss, this could undermine the international financial system, to say nothing of the competitive position of U.S. banks.

Systemic risk now transverses the oceans. All industrialized countries appear to have an implicit "too big" doctrine based on their actions since the great depression.

Let's go to the bottom line. Nobody really knows what might happen if a major bank were allowed to default. And, no one wants the opportunity to find out. When you consider cost factors along with unacceptable risk, most large bank failures in industrialized countries are likely to continue to be handled in a manner that gives substantial protection to the system.

Moreover, it is neither wise, nor practical, to set forth rigid rules for the "too big" doctrine. In order to maintain some market discipline, perhaps it is best not to provide absolute assurance in advance.

Gerald Corrigan, President of the Federal Reserve Bank of New York, calls this kind of reverse psychology "constructive ambiguity". Of course, financial market participants don't like uncertainty, but that's just the point!!

The circumstances of a particular case, the setting in which it occurs and the assessment of the relative costs and benefits of alternative courses of action have to be examined case by case.

When offering the federal safety net, even stretched to contain the "too big" doctrine, it is important to keep in mind that this policy is designed to protect banks only.

Under current policy guidelines, this federal protection does not extend to non-banking activities or bank owners, including bank holding companies.

But this discussion begs the real question. What we should be asking ourselves is how can we replace "too big to fail" with "too strong to fail"?

Or, to put it another way, how can we limit government's risk as an insurer by limiting excessive risk-taking in the banking system?

The customary approach is to focus on the liability side of banks' balance sheets.

Proponents of greater depositor discipline believe that reducing the level of deposit insurance will curb excessive risk-taking. But the success of this policy still turns on the question of whether the government will permit a large bank to penalize uninsured depositors with losses.

Unless the government is willing to inflict losses on depositors in the "too big" cases, then rolling back insurance coverage will not control the biggest government risk. What roll-back could do is increase the threat of financial instability and bank runs and--handicap smaller institutions.

We don't oppose reductions on the liability side that is in the amount of insurance. We just don't think a reduction of the insured amount is likely do much good in terms of reducing real costs to the insurance fund. Only a change designed to force depositors to pay a share of losses is likely to reduce costs.

Another approach is to tackle the problem from the asset side of banks' balance sheets. This has promise.

The basic idea is to restrict the risk to which we subject insured deposits. We can do this by putting riskier operations outside of the insured bank.

In its 1987 study, Mandate for Change, the FDIC proposed that banks concentrate on those less risky activities that they traditionally have engaged in. At the same time, banks could engage in new activities entailing a greater degree of risk as long as those activities were conducted through a separately capitalized subsidiary or affiliate.

Doug Barnard had the same idea when he introduced HR 1992, the Depository Institution Affiliation Act. We support Mr. Barnard's bill.

The FDIC study calls for restricting transactions between the banks and their specially created affiliates or subsidiaries. Penalties would be enforced to prohibit cross-dealing. This would,in effect, protect the banks with a "firewall." The "firewall" would separate all the traditional attributes of a bank, including insured deposits, from adverse consequences of new and risky business activities.

The need for banking regulators to supervise non-banking subsidiaries would be eliminated. Only functional regulation would be required.

This approach would allow banks greater competitive latitude. It would expand opportunities for banks to experiment and innovate. It would allow vast sources of new capital into the banking system, providing it with renewed strength. And it would allow banks, and the government, to carry a streamlined and less expensive regulatory burden.

Combined with potential loss to <u>some</u> large depositors, this approach could produce a stronger banking system and lower costs to the government.

Maybe it could even put an end to speeches about "too big to fail."

Thank you.