ORAL STATEMENT OF

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ON

DEPOSIT INSURANCE REVISION AND FINANCIAL SERVICES RESTRUCTURING

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

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Good Morning, Mr. Chairman and members of the Committee. I appreciate the opportunity to testify today on deposit insurance and financial reform.

You have asked for and I will give you my thoughts on how we need to change the financial system.

Our objectives in reforming the system should be:

First, to reduce the potential liability of the government for its safety net, particularly as an insurer of deposits.

Second, to maintain the stability of the financial system as the deposit insurance system has done so well in the past; and

Third, to increase the market orientation of the system, so we have a system that is competitive and consumer-oriented.

The foregoing is all we need to do to vastly improve the performance of the financial system in the United States and it's all we need to do to improve the ability of our financial institutions to compete successfully in the world economy.

Surely, with all the experience we have had with the S&L debacle, the tons of academic research provided to us, and the practical Yankee know-how which we have inherited, it should be possible to promptly proceed toward meeting these relatively simple and well-defined goals.

But, political history indicates that it will not be easy because reasonable people disagree on what should be done. Disagreement will be based both on intellectual analysis and economic interests.

Still, we must proceed to debate the issue to the point of action. As you know, the Treasury is conducting a review of these issues and we are participating, so my remarks are presented in the context of being a participant in that ongoing process.

What follows is the shortest of short-form outlines of my thoughts on this important subject. These thoughts may be jumbled by the recent efforts of my good quarter horse Primero -- but then again, perhaps his causing a little brush with mortality could have helped to focus the process. So let me refer again to our major objectives:

First, we must find a way to reduce the potential cost of the government's pledge to insure financial deposits. The present system is a bad bet for society -- it can cost too much for the value received.

To reduce the potential costs of insurance to the taxpayer, I would propose a three-fold approach.

(a) On the asset side we need to limit the kinds of investments that can be made with insured deposits. Only the kind of investments that experience indicates are reasonable, conservative and safe should use these insured deposits for funding.

Other ventures, such as low grade loans, direct investments, out-of-territory lending and non-bank related activities, should be funded by the market with no government guarantee. This should be done in separately capitalized entities whose failure will not jeopardize the bank, because by law the bank can not be liable for their activities and because the separate entities are not counted as part of the required capital of the banks. In large institutions this should be relatively easy to do. In small institutions, separate rules may be required.

(b) On the liability side the exposure of the government can be reduced by reducing what it is that the government agrees to insure. This means the "too big to fail" concept, 100 percent deposit insurance for large institutions, must be re-examined and restricted -- but in my view, this can be done only on an international basis.

(We have a conference on the subject planned this fall at the time of the IMF-World Bank meetings in Washington).

Further, we must look at insurance coverage with an eye toward restrictions on the amount of liability per customer. This reduction, for example, could include required co-insurance, reduced insurable amounts, or limited numbers of insured accounts per person, elimination of pass through insurance, and other means. None of these changes on their own will really make a big difference, but all should be explored as possible methods of chipping away at the government's exposure and reducing liability.

(c) On the structural side, changes can be made to achieve our goal of reduced liability. More capital, risk-based premiums and capital, and private co-insurance all have promise in this regard. Most important is to evolve a structure that separates insured deposits from risky ventures by using separate legal entities with the legal assurance of separateness. This is not firewalls in the sense of restricting inter-company activities, such as common name, etc., but assurance of separate legal status for liability determinations.

So, we must look at assets, liabilities and structure to find ways to control potential insurance costs.

To achieve our second objective of continued stability, we must make our changes in ways that do not jeopardize the costly and hard-bought stability we have brought to our financial system. I remind you that 9 out of 10 of the largest banks in Texas failed or would have failed without our or other help. The same can be said for 2 out of the 3 largest banks in Oklahoma. At the same time, hundreds of other banks failed, and yet the system did not panic into collapse. Although we certainly had some runs that were stopped by the safety net.

So, our changes to reduce costs must be done in a way that meets the following objectives required for stability:

* The average depositor must not be put at unreasonable risk.

* The method for handling large institutions must allow those with the responsibility to handle them in a way that does not destabilize the system.

* And the government must always be able to act to meet problems in the financial system where necessary, and with tools that are in place before crises arise.

To achieve our third objective, a system can operate safely and soundly only if it can provide competitive services to its customers at a <u>reasonable profit</u>. To make this possible our system needs to:

* Eliminate unnecessary restrictions on products and services. Glass-Steagall must go -- with safeguards in place that assure that insured deposits don't fund the new activities.

* Eliminate the Bank Holding Company Act's regulation of capital requirements. The separation of finance and commerce must go. The Act generally increases regulatory costs, reduces available capital and creates the most awkward and expensive structure that exists anywhere in the world.

* Eliminate geographic restrictions so that our institutions can compete as truly U.S. institutions rather than just New York or regional entities. This change can be put in place while retaining the flexibility and decentralized merits of the dual banking system.

Finally, with respect to changes in the <u>regulatory structure</u>, that is who regulates what, I believe restructuring should be based on the financial system that will evolve from the reform we have made. A reformed financial system first, a regulatory structure to fit that new system second.

As a general guideline, experience indicates that the independence of financial regulators and insurers is essential to accomplishing the task of supervising the financial system without bowing either to the current political fad or to potentially large economic pressures.

Further, banking supervisors should not be put in a conflict of interest by being responsible for other important public objectives, such as monetary policy, international economic stability, and revenue production.

Supervision can be more unified than it is today. But if it is, then it is even more important that it be kept independent of other public concerns and political pressures.

Well, that is all I can squeeze in, in the time allowed. Let me conclude with the thought, that the importance of getting on with these changes in our financial system cannot be overstated. Our economic future to a substantial degree may well depend on improving the performance of our financial system.