CBO TESTIMONY

Statement of
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Mr. Chairman, I appreciate this opportunity to appear before this Committee to discuss the Treasury Department's report on the federal deposit insurance system. This report, which contains a comprehensive review of the problems now plaguing the banking industry, provides an excellent point of departure for a discussion of the policy changes needed to ensure the economy has a strong and efficient financial services sector.

While many details of the Treasury Department's specific policy proposals are not yet fully developed, I would like to share with you the Congressional Budget Office's (CBO's) initial impressions of these recommendations. I will focus on three aspects of the Treasury report:

* The proposals to reform the deposit insurance system,

* The recommendations for restructuring federal agencies that regulate and supervise depositories, and

* The proposals to enhance the competitiveness of banking by further geographic deregulation and expansion of powers.

To place the discussion in context, let me start by discussing the broad principles and public interests that underlie government regulation of banking.

I will conclude by offering some thoughts about the urgency with which the various Treasury recommendations should be addressed.

POLICY OVERVIEW

The structure and operation of the banking industry is a legitimate matter for government concern and involvement because of three important roles played by depository institutions. First, banks (broadly defined to include commercial banks, savings and loans, and credit unions) maintain a "means of payments" system that is essential for operating a modern economy. Checks, drafts, and transfers are drawn on deposits as a means of facilitating transactions between buyers and sellers of goods, services, and assets. A loss of public confidence in bank deposits as a means of payment could cause bank runs and a sharp decline in the supply of money with severe macroeconomic consequences.

Second, depository institutions fulfill an important role of intermediation. They provide a secure and efficient means through which the savings and unused payments balances of people and businesses are pooled together and channeled into productive uses that foster economic growth. Depositories have provided funds for business, agricultural, and consumer loans as well as mortgages. Of course, depositories are not the only financial

institutions performing this role. To some degree, mutual funds, insurance companies, security brokerages, underwriters, government-sponsored enterprises, and other financial institutions fulfill this function. However, none of these institutions offers the combination of the security provided by federal deposit insurance, low transactions costs, and the convenient accessibility of ubiquitous banks.

The third reason for government involvement is that depositories are a critical component of the system through which the central bank conducts monetary policy. The Federal Reserve affects the pace of economic activity by changing the amount of reserves available to banks. Changes in bank reserves in turn affect the availability and cost of credit. A moribund depository industry would increase the difficulty of conducting monetary policy.

Because of the important role that depositories have played in the financial system, and because the banking collapse of the 1930s seriously impaired public confidence in the safety of deposits, the federal government began to insure deposits first at commercial banks (1933) and later at thrift institutions and credit unions. This insurance guarantees the safety of deposits used either for payments or as a form of savings. Along with deposit insurance came banking regulation which was intended to control the amount

of risk that depositories undertook and to protect them from excessive competition. Of course, public policy toward the financial sector has also been concerned with other goals, such as equity and efficiency. Recent developments have created a broad consensus that the existing systems of depository regulation and deposit insurance, which have not been changed substantively since the 1930s, are in need of major overhaul.

Recent Developments in Commercial Banking

The restrictions placed on banks in the early 1930s were based on the premise that limiting the intensity of competition and the riskiness of activities in which banks could engage was necessary to achieve a safe depository industry. These included restrictions on entry into banking, payment of interest on deposits, investment powers and securities activities, and the ability to offer insurance. The premise underlying this regulatory framework has been questioned in recent years as new research has refuted widely-held views of the causes of the 1930s' banking collapse and as modern portfolio theory has led to a revision in the prevalent view of risk and diversification. The generally satisfactory foreign experience, where banks are permitted to engage in a much broader range of activities, has also had an impact. But the major

factor contributing to the revised view of the effectiveness of regulation has been developments in the marketplace.

Beginning in the 1960s, the protected market position that regulation afforded depository institutions began to erode. Ceilings on the interest rates that banks and later thrifts could pay on deposits became a problem. They were undermined first by the banks themselves and then by increases in market interest rates that induced depositors to purchase open market financial instruments such as Treasury bills or commercial paper or to purchase shares in the newly established money market mutual funds, a process known as disintermediation. The results were temporary disruptions in credit markets and shrinkage in the market share of commercial banks.

More and more, large businesses began to bypass the intermediation banks provide and borrow directly from the nonbank public through the issuance of commercial paper and other instruments. As a result, depositories began to lose precisely those customers whose size and creditworthiness contributed so much to their safety, forcing them to search for business among less creditworthy firms.

In and of itself, a decline in the market share of banks need not be viewed with alarm; the relative success of different types of institutions is not

normally an issue of public policy. However, several facts make these particular changes a matter of public concern. First of all, the decline in the competitiveness of depository institutions was in part a consequence of regulatory changes. Second, the development of money substitutes by nondepositories changed the relationship between money and total spending in ways that may make the conduct of monetary policy more difficult. Third, and most important, the decline in market share is one manifestation of the failure of deposit insurance and other banking laws and regulations to achieve their intended result of maintaining the profitability and safety of depository institutions. No deposit insurance scheme can be effective if the underlying industry is under chronic stress.

REFORM OF DEPOSIT INSURANCE TO ENSURE SAFETY, EQUITY, AND EFFICIENCY

The Treasury Department has advanced a comprehensive package of recommendations to correct the deficiencies of the deposit insurance system and minimize taxpayer loss. Central to the Treasury's strategy is the determination that the public safety net afforded by deposit insurance has been extended beyond its original intent, which was to protect small depositors. In addition, the Treasury recognizes that, as with other forms of insurance, deposit insurance creates a moral hazard--an incentive for

depositories to undertake higher levels of risk. Perhaps most important, the Treasury's proposals are motivated by the recent experience of the thrift crisis and the high cost that thrift failures have imposed on taxpayers.

The Treasury recommendations would narrow the scope of deposit insurance coverage and improve methods of containing moral hazard. They would do so primarily by strengthening the role of capital requirements in the supervision and discipline of riskier depositories, but also by charging a premium for deposit insurance that varies with the riskiness of a bank's assets relative to its capital. These recommendations recognize the interrelated aspects of the problems that have recently plagued the deposit insurance system. If effective, these recommendations should lower the exposure of taxpayers to future costs and make the banking system safer. However, as CBO pointed out last fall in, Reforming Federal Deposit Insurance. no single proposal is capable of achieving all of the goals of reform, and each carries some disadvantages along with the advantages it seeks to achieve.

Narrowing Coverage

The Treasury report notes that the scope of deposit insurance coverage has effectively been extended beyond that intended when the permanent system was established in 1935. The Treasury recommends that coverage be narrowed by restricting the number of qualified insured accounts an individual may have to two and eliminating coverage for Bank Insurance Contracts, passthrough, and brokered accounts. The objectives of narrowing insurance coverage are twofold: to lower the contingent liability of the deposit insurance system and to encourage large depositors to exert more market discipline on the risk-taking of depositories.

Narrowing coverage would impose more of the costs of failure on depositors. Thus, it would provide them with a greater incentive to monitor their depository's behavior and would increase the sensitivity of the depository's cost of funds to its risk-taking. Over longer periods of time, this would enhance the incentive of depositories to manage their assets prudently and to maintain adequate levels of capital, thereby lowering the likelihood of failure and accompanying systemic risk.

But increased market discipline also increases the probability of runs on institutions perceived as unduly risky, the prevention of which is viewed by many as the primary goal of deposit insurance. This apparent dilemma in proposals to rely more heavily on market discipline can be reconciled. Recent studies suggest that bank runs, contrary to popular belief, have generally been constructive phenomena, disciplining risky banks and rewarding sound banks as depositors transfer funds from the former to the latter. Runs are to be feared mainly when they spread to healthy institutions. Increasing market discipline need not significantly raise the chance of such contagious runs if banks respond to increased market discipline by changing investment policy or by adjusting returns on borrowed funds. Even a small risk of contagious runs is worrisome, but it may be preferable to accept a small risk of contagious runs in exchange for the benefits of greater market discipline.

Capital as a Tool of Regulation

The owners of depositories should normally bear losses resulting from excessive risk-taking and, therefore the capital of an insured depository is the first line of defense of the deposit insurer. In view of this function of capital and the incentive it provides owners to operate their institutions in a safe and sound manner, it is not surprising that capital positions--specifically, the actual

levels of depositories' capital relative to required levels based on their risk-weighted assets--play a central role in nearly all of the Treasury's recommendations with respect to deposit insurance and regulation.

In at least three specific ways, depositories' capital positions are used to guide or carry out regulation under the Treasury's recommendations.

* Depositories are classified into one of five zones based on the relationship between their actual book capital and their required capital based on risk-weighted assets, with Zone 1 being the best-capitalized and Zone 5 the worst. Institutions in Zone 1 are subject to much less stringent regulation than those in the other four zones. Indeed, supervision becomes progressively more stringent as the depository moves successively from Zone 1 to Zone 5, with mandatory corrective actions triggered by each move to a higher-numbered zone. Only Zone 1 institutions would be permitted to enter the new securities and insurance activities advocated by the Treasury, and they would be required to divest such activities if they fell below that zone. At the other extreme, Zone 5 institutions would be placed in mandatory conservatorship unless they could raise sufficient additional capital within a very short period of time.

* Insofar as possible, depositories would be resolved before their capital became negative in order to minimize losses to the insurance funds and, ultimately, taxpayers. Forbearance would become the exception, rather than the rule, and would have to be agreed to by both the Treasury and the Federal Reserve.

* Deposit insurance premiums would vary according to the capital position, with lower rates for the better capitalized banks.

Each of these uses of the capital positions of depositories would improve the regulation of insured institutions. However, the manner in which they would be implemented gives rise to some concerns. Taken together, these proposals place a heavy burden on the formula for risk-based capital requirements agreed to under the Basle Accords. Although clearly "a step in the right direction," this formula may not be ready to bear this load for several reasons.

First, the risk weights assigned to the various asset categories have not been systematically validated as good measures of default risk. Second, the small number of distinct risk categories, five at present, means that the assets included within any one of the categories are extremely heterogeneous. In the loans category, the same risk weight is assigned to relatively safe short-term

secured loans as to long-term unsecured loans with higher probabilities of default. Only residential mortgages are given a preferential weight. Thus, without affecting its required capital, a depository could load up its portfolio with higher-risk loans defeating the whole purpose of risk-based capital requirements. (The Treasury does recognize one important deficiency of the current risk-based capital standards--that is, their failure to take interest rate risk into account. Accordingly, it would require the Federal Deposit Insurance Corporation (FDIC) to develop an adjustment for differences in such risk within a year after the legislation was adopted.)

Having said all this by way of caution, it is appropriate to note that the brunt of the evidence is that even these simple risk-based capital requirements appear to be better than the old unweighted capital-to-assets ratio as a harbinger of distress. As such, a good case can be made for moving in this direction, but to regard the move as a first step in perfecting the new standards.

Risk-Related Premiums

Currently, deposit insurance premiums are levied using a uniform rate for all institutions regardless of the risk that they present to the insurance fund. This

practice has been the subject of much criticism because it provides an advantage to riskier institutions and exacerbates the problem of moral hazard. The Treasury recommends carrying out an insurance pricing scheme that would vary premiums to reflect the risk of individual depositories. The proposal would measure risk on the basis of an institution's capital adequacy.

For many years, most academic economists have viewed risk-related premiums as the preferred approach to deposit insurance reform. Such an approach would emulate the practice of private insurers. However, regulators who would be charged with implementing the premiums have contended that such a scheme would be impractical, ineffective, or impossible to establish. In particular, they have cited the difficulty or impossibility of measuring risk sufficiently accurately to serve as the basis for such premiums.

Regulators share a widespread misconception that, for risk-related premiums to be effective, risk must be measured perfectly. That is by no means the case, as can be readily seen by considering some of the extremely crude risk proxies and categories private insurers employ. (Does anyone really believe that, upon reaching the age of 25, male drivers immediately cease being reckless behind the wheel and thereafter become defensive drivers?) In addition, bank examiners are probably not as inept at measuring

risk as they claim to be; if they are, bank examination and prudential regulation make little sense.

Similarly, the concern of regulators that they might overcharge some institutions for the risks they are taking is peculiar in view of the many more serious indignities that are visited upon depositories on the basis of judgments about risk that are no more accurate. For example, commercial banks are excluded from buying equities, lending more than a certain percentage of their capital to one borrower, and investing more than a limited amount of their assets in real estate loans--all on the basis of imprecise but presumably meaningful, estimates of risk. Such estimates can also be the basis for cease and desist orders and ultimately the removal of management. Why the reluctance to charge depositories a higher premium for what is perceived as riskier behavior when their managers and directors can be removed from office for the same behavior?

The Treasury study does not explicitly describe how a bank's capital position would be translated into a specific premium rate under a system of risk-based premiums. If the current risk-based capital formula were used to generate premium differences, these differences might amount to no more than a few basis points. However, to be effective and have a strong impact on the risk-taking behavior of banks, risk-related deposit insurance premiums

would have to differ by several hundred basis points between the safest and riskiest banks. If premiums differ by only small amounts, it may not be worthwhile adopting risk-related premiums.

The alternative means of assessing risk-related premiums suggested by the Treasury--contracting with private reinsurers--should yield a useful basis for comparison with the premiums generated using the current risk-based capital standards. One major potential difficulty with this proposal is the absence from the Treasury recommendations of an explicit rule for closing failing banks. Perhaps the major lesson of the crisis in the thrift industry was that the most important factor in determining ultimate losses is the time of closure. However, although the Treasury report strongly supports the concept of early closure, it does not make it mandatory, nor does it specify a precise rule governing closure. Without such a rule, private reinsurers will have no good basis for estimating their likely losses.

The Issue of Too-Big-To-Fail

Probably the critical issue to be decided in reforming regulation of depository institutions is whether some depositories are so important to the financial system or the economy that they require special treatment in the event of

their insolvency. After the collapse of the Continental Illinois Bank in 1984, the Comptroller of the Currency indicated that the banking regulators viewed some banks, including Continental, as too large to be permitted to fail because their demise would destroy confidence in the banking system and increase the probability of contagious bank runs. In practice, the Comptroller, the FDIC, and the Federal Reserve have treated the prospect of the failure of larger institutions much differently from that of smaller depositories. This controversial policy has raised serious issues concerning equitable treatment of insured depositories, effects on the efficiency of the industry, incentives to limit risk-taking, and the de facto extension of federal deposit insurance to uninsured creditors of large banks and thrifts. Although most often characterized as a "too-big-to-fail" policy, this policy is probably more accurately described, as one of "too-big-to-liquidate" or "too-big-to-inflict-losses-on-uninsured-creditors."

The Treasury recommends that protection of uninsured depositors become the exception rather than the rule, although it still permits a significant loophole. This loophole is embodied in the rule that the FDIC must use the "least cost" method of resolving an insolvent institution. Using this rule, liquidations are rare and typically applied only to smaller institutions. Generally, the "least cost" method leads the deposit insurer to seek an acquirer to purchase the institution's assets and assume its liabilities.

The purchase and assumption method of resolution has typically resulted in the guarantee of uninsured depositors and general creditors, although there is no reason in principle why "haircuts" cannot be imposed on holders of uninsured liabilities.

The Treasury also recommends that it and the Federal Reserve retain the flexibility of deciding, in cases where they jointly find systemic risk, to fully protect uninsured depositors. In essence, this exception to a policy of immediately closing insolvent or noncompliant institutions is tantamount to retaining the "too-big-to-fail" doctrine. In cases involving systemic risk, the decision to make uninsured creditors whole is likely to increase the cost to the insurance fund, and a good argument can be made that taxpayers in general, rather than insured depositors or depositories, should be called on to make up the difference. One point on which virtually all observers now agree is that the adequacy of resources of the deposit insurance fund should not dictate whether a particular institution is considered "too-big-to-fail." In order to limit the application of the doctrine, it may be necessary to ensure that the insurance fund has resources beyond those accumulated from deposit insurance premiums.

In practice, there is an important but little-noted constraint on the ability of the regulatory agencies to impose losses on uninsured creditors.

Recently, many large creditors have taken the precaution of insisting on having their money secured by specific assets of their depository institutions. When institutions have failed, the regulators have been legally bound to honor these agreements, leaving only a portion of the depository's assets to defray the losses of the insurance fund or other unsecured creditors. The remedy would appear to be a statutory limitation on such agreements. Although such a restriction would clearly increase the cost of funds to depositories and make it much more sensitive to the risks of the institution, that is precisely what is needed if uninsured creditors are to fulfill their role of exercising market discipline.

It is therefore unclear how the Treasury recommendations improve on current policies. Indeed, it has been argued that carrying out a policy whereby no institution is considered to be "too-big-to-fail" or "too-big-to-liquidate" would result in lower costs to the deposit insurance system over the long run, if not in every individual case. If the uninsured creditors of depositories know that regardless of the size of their institution, they stand to lose some or all of their investment if the institution is taken over by the deposit insurer, they are likely to exercise more market discipline and institutions are likely to behave more prudently. Despite the plausibility of this argument, however, only a real-world experiment could demonstrate its validity.

In some respects, the real issue here is the appropriate degree of discretion to be accorded regulators. The policy choice is between adopting strict rules governing when and under what circumstances various regulatory measures, including closure, will be applied and the alternative of allowing the regulators considerable discretion in deciding what to do in particular circumstances.

Whatever the arguments in principle, experience has shown that regulatory discretion tends to lead to delay, both in applying regulatory sanctions and, ultimately, in closing insolvent institutions. It also fosters a tendency to extend the protections of deposit insurance beyond those explicitly covered in deposit insurance legislation. Because of this well-documented tendency--perhaps understandable on the part of regulators intent on avoiding a major financial debacle and uncertain as to the consequences of their actions--a strong case can be made for narrowing the range of regulatory discretion. Whether the disposition of insolvent large banks should be inside or outside the narrow range of regulatory discretion is a hard call.

Dissatisfaction with the current structure of federal regulation and supervision of depository institutions has been expressed on many occasions in recent decades. There have been repeated calls for rearranging the responsibilities of the bank regulatory agencies to reduce the number of agencies, eliminate overlapping jurisdiction and duplication of effort, and provide appropriate incentives for strict but not overly oppressive regulation. The only regulatory restructuring of any consequence since the 1930s occurred in 1989, when FIRREA abolished the Federal Home Loan Bank Board (Bank Board), replaced it with the Office of Thrift Supervision (OTS) located within the Treasury, and entrusted the FDIC with administering the Savings Association Insurance Fund, the successor to the FSLIC.

The Treasury recommended significant further restructuring, specifically, that the existing four federal regulators of depository institutions (other than credit unions)--the Office of the Comptroller of the Currency (OCC), the FDIC, the OTS, and the Federal Reserve--be reduced to two by merging the OTS with the OCC to form a new Federal Banking Agency (FBA) and by eliminating the FDIC's supervisory responsibilities. Under the proposal, the Federal Reserve would regulate all state banks and their holding companies

and the FBA, which would be housed in the Treasury, would regulate national banks, thrift institutions, and their holding companies.

The Treasury recommendations partly achieve the goals of earlier proposals for restructuring regulatory agencies, but they introduce new controversy. Its proposal would reduce the number of agencies by relieving the FDIC of its supervisory authority. This approach is based on a presumed conflict of interest "in having a single regulatory agency simultaneously promote and protect an industry." While this presumption may have applied to the Bank Board and the FSLIC, there is no such conflict in the FDIC, which does not have a mandate to promote banks. Indeed, combining responsibility for supervision of banks and stewardship of the deposit insurance fund provides mutually reinforcing incentives toward maintaining sound depository institutions.

To eliminate overlap, the Treasury has recommended that responsibility for supervising most depository institutions be divided between two agencies. While there may be some advantage to splitting responsibilities between the Federal Reserve and the new FBA, the proposed division appears somewhat arbitrary. For example, the Federal Reserve is not allowed to devote its full time and effort to monetary policy, nor is it given authority over all of the institutions most likely to create systemic problems--that is, the 50 or so

largest banks. Also unclear is whether it is advantageous that the proposed FBA should be subordinate to the Treasury. Some would argue that the supervisory agency should be independent in a fashion similar to that of the FDIC or the Federal Reserve.

PROPOSALS TO ENHANCE COMPETITIVENESS

The deposit insurance system cannot be put on a firm footing unless the industry is sound and healthy. Many of the Treasury's recommendations focus on proposals to enhance the competitiveness of depositories. It specifically recommends deregulating geographic restrictions on branching by national banks, expanding the securities and insurance powers of depositories, and eliminating barriers to ownership of commercial banks by nonfinancial firms.

Branching

The Treasury's recommendations that the Douglas Amendment, which gives individual states control over interstate expansion by bank holding companies, be repealed and that the McFadden Act be amended to permit interstate branching by national banks make sense from the point of view of creating a

more rational and efficient banking structure. In virtually no other industry are the states allowed to impose such geographic restrictions on the operations of individual firms. The interstate banking compacts entered into by the state legislatures over the past decade have moved us far toward a system of nationwide banking, albeit exclusively through the establishment or acquisition of separately incorporated subsidiaries of holding companies. It is not readily apparent that banking organizations should be denied the right to choose the particular form of internal organization that they find most efficient. Permitting banks greater authority to branch, however, will alter the structure of the banking industry and lead to a reduction in the number of independent banks in the country. It also may mean that many more communities will no longer have locally established banking institutions.

There appears to be general agreement among economists regarding the desirability of expanded branching. Many of the historic reasons for prohibiting nationwide branching are now viewed as less than compelling. For example, the oft-expressed concern that expanded branching will lead to monopoly in banking ignores the fact that monopoly is largely a result of concentration and barriers to entry at the local market level. Branching promotes entry into such markets and, though leading to consolidation and increased concentration at the state and national levels, has historically resulted in reductions in local market concentration. If additional defenses

against monopoly are needed, they could take the form of stricter restrictions on mergers and limits on concentration, as opposed to limits on geographic expansion.

Another longstanding objection to wider branching is that it will result in the draining of funds from some communities for lending elsewhere. Branching does foster much greater mobility of funds than a unit banking system provides. This argument, however, can also be used to support broader branching. By facilitating the flow of credit to those areas where it commands the highest returns, branching tends to improve the efficiency of allocating credit nationwide. The argument that depositors' funds should be "kept at home" for reinvestment in the local community ignores the fact that the interests of local depositors and borrowers do not always coincide. Lending the funds locally may be consistent with some notion of equity of access to credit by small or isolated borrowers, but inconsistent with maximizing returns to depositors.

In studying different states, it is very hard to make the case that in those states with branching, there is any widespread discrimination against small borrowers or rural interests. Moreover, in heavily branched states like California, small banks coexist with the giants as a result of specialization and

"niche" services. The burden of proof has shifted to those who want to continue restricting the location of banks.

Expanded Insurance and Securities Powers

The Treasury's recommendation that banking organizations be permitted to engage in a wider range of brokerage, underwriting, insurance, and other financial services also appears to be constructive from a strictly economic point of view. The traditional argument for restrictions on such activities has been that there is a high degree of risk for institutions that commingle commercial banking with brokerage or insurance activities. There is some reason to believe, however, that important informational advantages exist between banks' traditional lending activities and securities underwriting, dealing, and investing that may outweigh the risk of commingling. Moreover, many analysts have argued that the risk of commingling is greatly overstated. The Treasury's proposal that such nontraditional activities be conducted by separately incorporated affiliates subject to rigorously enforced firewalls, and only by the best capitalized institutions, offers the hope that this enlargement of bank powers can be undertaken without unduly extending the federal safety net.

The competitive inroads made into the U.S. corporate lending market by Japanese and other foreign banks and the imminent creation of a unified European banking market under the Economic Community's Second Banking Directive have added urgency to the U.S. banking industry's call for new powers. By allowing banks headquartered in any member country to exercise anywhere in the Economic Community the powers they enjoy in their home country, the EC directive provides strong incentives for member countries to liberalize their banking laws. Several of the EC countries already permit their banks to provide a wide gamut of services, under one roof. U.S. banks profess to be under pressure from their customers to provide the same combination of services as their European competitors. Indeed, international agreements based on the principle of reciprocal treatment may hinder U.S. banks in competing abroad by preventing them from engaging in activities permitted domestically chartered banks in foreign countries.

The Treasury study places considerable emphasis on the diminished stature of the largest U.S. banks as measured by their rankings among the world's banks. This emphasis may be misplaced and does not necessarily reflect that U.S. banks are becoming less competitive internationally. The competitiveness of U.S. banks in world financial markets should be measured on the basis of aggregate market shares, not by the rankings of individual banks. While both individual rankings and aggregate figures are subject to

distortion by short-term fluctuations in exchange rates, assets of U.S. offices of foreign-owned banks as a proportion of total bank assets in the United States grew only from 18 percent in 1986 to 22 percent in 1990.

A figure that may be more significant is that foreign banks increased their share of wholesale banking in the United States from 14.2 percent in 1980 to 28.3 percent in 1988. While benefiting domestic borrowers through increased competition, this expansion of foreign market share is a matter of legitimate concern to domestic bankers. This concern may be short-lived, however, because the rapid growth of foreign bank lending could be transitory. For example, the strong capital/asset ratios that enabled Japanese banks to increase their share of U.S. domestic markets have been sharply lowered by the decline in prices of Japanese stocks.

One should caution against expecting too much too soon from expanded insurance and securities powers in terms of their immediate contribution to the earnings and capital positions of banks. Although such powers may enhance the long-term competitive position of U.S. banks relative to foreign banks and domestic nonbank competitors and may even result in a modest reduction in the variability of earnings, they do not promise any short-term miracles. Indeed, many banks that rushed to enter the London securities markets following the much-publicized "Big Bang" deregulation of 1986 have

since withdrawn, wiser but considerably poorer. Domestic securities firms also underwent a painful shakeout and consolidation in the late 1980s. Recently, some insurance companies have experienced losses on assets. This is not to deny that selected opportunities for profitable expansion exist, but only to emphasize that expanded powers do not constitute a panacea for the ills of the banking industry.

Ownership of Banks by Commercial Firms

In contrast with its proposal for expanded powers, the Treasury's recommendation that commercial enterprises be permitted to own banks is supported by little evidence of the advantages to be achieved. No convincing arguments have been advanced to indicate that there are major advantages to be achieved by ownership that combines banking and nonfinancial activities.

The primary benefit of permitting commercial ownership is that it would increase the availability of capital for depositories, but it is not clear that much new capital is needed. While it is widely accepted that it would be desirable for U.S. depositories to increase their capital ratios, measured relative to either total assets or risk-weighted assets, there is no corresponding

presumption that the aggregate amount of capital in the depository industry should increase. In fact, many analysts have argued that the real problem is that too much of the economy's capital is in depository institutions. This problem is reflected in the inadequate rates of return banks earn on existing capital. If so, the remedy for this problem is a contraction rather than an expansion of the industry.

LEGISLATIVE PRIORITIES

Release of the Treasury's recommendations for reform of the U.S. financial system presents the Congress with an imposing array of interrelated proposals for legislative action. I would like to close by offering some thoughts on how these proposals may best be addressed to maximize their potential benefits, while minimizing the costs associated with the transition to a new financial services regime.

The long-term benefits sought by some reform proposals will probably come only after some short-term costs have been incurred. Therefore, the agenda for reform should take into account the likely sequence of costs and benefits and consider whether some changes should be made conditional on favorable circumstances within the depository industry and enactment of other

key elements of the reform package. For example, it may make sense to enact those reforms that provide incentives for the safe operation of depository institutions and ensure greater safety of deposited funds before taking up measures that may increase the long-term efficiency and profitability of banks, but which could have the short-term consequence of jeopardizing less efficient institutions.

Recapitalization or Refinancing of the Bank Insurance Fund

Although not spelled out in the Treasury reform recommendations, ensuring that the BIF has sufficient resources to deal with any potential financial claims resulting from additional bank failures must rank at the top of any agenda for policy attention. The BIF needs additional resources to deal with its anticipated short-term insolvency and liquidity problems. Legislation may be required to provide these resources. One clear lesson of the thrift crisis was that delay in closing failed institutions because of financial constraints of the deposit insurer added greatly to the costs of resolving them. Making sure that the BIF has enough money to resolve failed banks in a timely fashion is critical to keeping costs down. A different but related priority is the need for recapitalizing the Resolution Trust Corporation to ensure that it can continue

to resolve failed thrifts. These steps are critical to maintaining the public's confidence in depositories in general.

Reform of the Federal Deposit Insurance System

The Treasury Department is to be commended for providing a starting point for the Congressional debate on deposit insurance reform. The recommendations would narrow coverage, strengthen capital requirements, improve supervision and vary premiums according to risk. The deposit insurance system and the taxpayer could be severely strained if changes in bank powers and bank regulations preceded these reforms. The recent history of the savings and loan bailout, as well as the looming potential for a large number of bank insolvencies, makes the reform of the federal deposit insurance system a high priority.

The Federal Agency Structure of Depository Institution Regulation

The Treasury argues that the time has come to consider restructuring the agencies responsible for safeguarding the public interest in depository institutions and reapportioning their responsibilities. The current regulatory

structure has been criticized for being inefficient and, at times, ineffective. While there may be benefits from rationalizing the current regulatory structure, it is not clear that the Treasury's recommendations on this issue would achieve this goal.

Reforming Regulation of Bank Powers

Proposals to change the regulation of depository institutions may be critical to the long-run viability of the banking industry. This is especially true in light of the substantially increased internationalization of the financial services market. Permitting depositories greater flexibility in their securities and insurance powers may ultimately decrease the risk to the deposit insurance system, but it may also impose short-term costs on that system. Permitting federally chartered depositories to branch across state lines, subject to the same limits as state chartered depositories, may also permit greater geographic diversification of risk and greater economic efficiency. Before adopting such reforms, however, the regulatory and federal deposit insurance system must be prepared to deal with the changes that such reforms would create.