Mark W Olson: Are banks still special?

Remarks by Mr Mark W Olson, Member of the Board of Governors of the US Federal Reserve System, at the Annual Washington Conference of the Institute of International Bankers, Washington, DC, 13 March 2006.

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Thank you for inviting me to speak to you today. Over the past twenty years, I have attended many of these Institute of International Bankers (IIB) spring conferences in Washington, D.C., either as a speaker or a participant. These meetings continue to address interesting and pertinent issues. The consistently larger number of attendees at a meeting here in Washington, as opposed to a meeting in one of the more dynamic international financial centers like New York or Los Angeles, reflects this group's clear recognition that public policy has a direct impact on the viability of your respective institutions. Appropriately, most of the topics presented over these two days cover legislative and regulatory issues intermixed with critical strategic issues. For my presentation, I will revisit a topic initially raised twenty-four years ago by a former president of the New York Federal Reserve Bank, E. Gerald Corrigan. In 1982, Jerry Corrigan, then the president of the Minneapolis Federal Reserve Bank, wrote an essay entitled "Are Banks Special?" for the Bank's annual report. Today I would like to revisit the issue and ponder the question "Are Banks Still Special?"

I realize that some of you may be wondering why a focus on the specialness of the domestic U.S. banking industry would be an appropriate topic at a meeting of foreign bank representatives. There are several reasons why the subject is relevant to this group. First, U.S. laws and regulations for foreign banks adhere to the fundamental principle of national treatment. That is, our regulations allow foreign banks to have the same range of product authority as domestic banks. Therefore, any change in policy that affects domestic banks will also potentially affect the range of products foreign banks may offer. Another reason why the issue is likely to be of interest to this audience is that, in any discussion of product authority or regulatory structure, the experiences of other nations are often used as examples. These examples are often presented as policies or practices to be avoided or emulated. But the accuracy of the facts presented to support or oppose other countries' experiences is not always clear. At times, these "facts" may be undocumented generalities or even wild speculation.

Let me return to Corrigan's essay. In 1982, the banking industry was facing an identity crisis unlike any it had faced since the Depression era fifty years earlier. Within a period of a few months in the mid-1930s, Congress (1) required the separation of banking from many securities functions by passing the Glass-Steagall Act, (2) provided protection for bank depositors by passing the Federal Deposit Insurance Act, and (3) authorized the creation of a dedicated home mortgage lender by passing the Home Owners' Loan Act. Through these laws, Congress established the legal framework that clearly delineated the competitive relationship for the securities, banking, and thrift industries for close to fifty years. This delineation extended to the marketplace for the banking and securities industries. During this period, there were few issues of controversy between banks and securities firms, the most notable exception being the narrowly focused but heated disagreement as to whether banks should be allowed to underwrite revenue bonds. The Glass-Steagall Act specifically authorized banks to underwrite general obligation bonds, but the act was silent on the issue of revenue bonds. The banking industry viewed that as an oversight; the securities industry viewed it as a purposeful exclusion. This debate went unresolved until 1999, when the Gramm-Leach-Bliley Act specifically authorized revenue bond underwriting by banks. In contrast to the relative peace between banks and securities firms, the competition for deposits between banks and thrifts was quite strong and intensified with the imposition of Regulation Q. Not only did Regulation Q establish ceilings on interest rates for both passbook savings accounts and certificates of deposit (CDs), the regulation gave thrifts an interest rate advantage of initially 50, then 25, basis points for each of their interest-bearing products. The intense marketplace competition between banks and thrifts was matched by the level of competition in the halls of Congress. Bankers aggressively worked to eliminate that quarter-point rate differential, while thrifts worked equally hard to preserve it.

Such widespread competition was nonexistent between the securities and banking industries. From the 1930s to the late 1970s, there seemed to be a clear distinction between investment and savings or at least between investment dollars and savings dollars. Savings dollars were held in passbook accounts or CDs, and were insured up to certain limits by Federal Deposit Insurance Corporation (FDIC) or Federal Savings and Loan Insurance Corporation (FSLIC) insurance. Investment dollars were in equities or bonds. Banks and thrifts waged a turf war against each other, but neither industry aimed its marketing guns or lobbying efforts at the securities industry. Then along came money market mutual funds, or money funds.

High interest rates during the late 1970s and early 1980s had a stunning effect on the flow of deposits into banks and thrifts. Money fund shares issued by investment firms offered market interest rates and a high level of liquidity, through either immediate withdrawal or the ability to effect transactions by using payable-through drafts. By contrast, Regulation Q mandated low interest rates on passbook accounts, specific term restrictions on CDs, and significant penalties for early withdrawal. Money funds offered rates that were at times double the rates on passbook accounts. The banking industry had no products to counter the market appeal. Even though money funds shares are not federally insured, billions of dollars flowed into the accounts. In 1981 alone, $109 billion flowed into money funds. After a tepid and wholly unsuccessful effort by bankers to restrict the growth of money funds, the banking industry began considering a different response. Now that the securities industry had successfully breached the separation between banking and savings by allowing consumers to invest in money funds, the banking industry was forced to examine its fundamental marketplace role. During that period, I was the vice chairman, then the chairman, of the Governmental Relations Committee of the American Bankers Association. At meetings held between 1980 and 1982, as many as 400 bankers representing institutions of all sizes and markets gathered to consider an industry response. Congress's response to the growth of money funds was to pass the Monetary Control Act of 1980 and the Garn-St Germain Act of 1982. Taken together, these laws, along with other provisions, eliminated many of the rate and term restrictions on banks' and thrifts' deposit taking and allowed both types of institutions to offer products that could match the rate and liquidity provisions of money funds. But it was clear to many bankers that a lasting response to marketplace changes would require more than just the removal of Regulation Q. Bankers were seeking answers to such basic questions as "What is a bank?" and "What is the public purpose of banking?" Jerry Corrigan's essay proved to be a beacon of rationality in that discussion.

Are banks special?

Corrigan identified three characteristics that made banks special:

- Banks and only banks offered transaction accounts. That is, "they incurred liabilities payable on demand at par and are readily transferable by the owner to third parties." That transaction account authority helped "to insure that financial disruptions do not spread." Backed also by deposit insurance and access to the discount window, banks "reinforced public confidence that is essential to a healthy economy."
- Corrigan's second criterion identified banks as critical backup sources of liquidity. In fact his essay stated that "banks are the primary source of liquidity for all other classes and sizes of institutions, both financial and nonfinancial."
- The third characteristic Corrigan identified is that banks "are the transmission belt for monetary policy. That role combined with operating the payments mechanism permit the highly efficient financial markets to function and effect the orderly end of day settlement."

Corrigan went on to address the question "what is a bank," a question that had been complicated by different definitions in different laws. The Federal Deposit Insurance Act defined "bank" differently than the Bank Holding Company Act did, a distinction that allowed commercial entities to own FDIC-insured banks by narrowing their product offerings to meet the BHC Act test. (The Competitive Equality Banking Act reconciled these definitions in 1987.) If banks are special, Corrigan stated, limitations on what services and lines of business banks could offer were justified. Further, the services of businesses that are allowed to be owners of banks should reflect in a nearly symmetric way, the services banks are allowed to offer. Corrigan had made a remarkably prescient observation, as the Gramm-Leach-Bliley Act that would be passed seventeen years later essentially adopted that last criterion in determining what types of corporations could own banks, and what activities could be conducted in those corporations. Between the publication of Corrigan's essay and passage of the Gramm-Leach-Bliley Act, market forces, supported by either regulatory interpretation or court challenges, continued to blur the lines between the banking, securities, and insurance industries. As capital markets expanded, mutual funds put pressure on bank deposits. In Europe, foreign bank successes in securities activities suggested that banks conduct these activities in a safe and sound manner. But until 1999, there was no legislative response to these basic marketplace changes or to the broader question of the separation of banking and commerce.

Separation of banking and commerce

The appropriate separation of banking and commerce is a delicate proposition that has both historical and philosophical underpinnings. The term "separation of banking and commerce" can mean different things, depending on the perspective of the person using the term. At the time of Corrigan's essay--the early 1980s--the statutory authority for that separation was largely contained in two laws: the Glass-Steagall Act, which separated commercial banking from certain investment and securities activities, and the Bank Holding Company Act (with amendments), which narrowly limited the activities of corporations that were allowed to own banks. When it passed in 1956, the Bank Holding Company Act was thought to have been in response to one company's aggressive expansion into banking activities. That company, Transamerica Insurance, had expanded into several western states and concerns were raised about the resulting concentration of financial resources. Therefore, the ensuing body of law on the commerce and banking issue concentrated significantly on separating, or was inspired by desire to separate, banking from securities or banking from insurance. From the time of Corrigan's essay until passage of Gramm-Leach-Bliley, the banking industry had expanded substantially into both the securities and insurance agency fields, though significant restrictions still remained.

Much of the industry's expanded securities authority was gained through the Federal Reserve's approval of securities underwriting for banks, under Section 20 of the Glass-Steagall Act. Under the Federal Reserve's rule, a bank subsidiary was "not engaged principally" in securities underwriting if at first 5 percent, then 10 percent, and ultimately 25 percent of its revenue came from underwriting. This expanded authority allowed many banking organizations, though almost exclusively large banks, to significantly expand their domestic securities activities. These same powers were extended to foreign banks operating in the United States.

In insurance, gains for the banking industry were largely the result of court determinations that annuities could be underwritten and sold by banks. Court determinations also expanded national banks' ability to market insurance products. Consequently, banks of all sizes have expanded their involvement in insurance and annuity activities.

By 1999, banks and bank holding companies had gained significant additional product authority in securities and insurance, areas that had been perceived to be on the other side of the banking and commerce wall at the time Corrigan wrote his essay. A number of factors persuaded Congress that federal action was appropriate, and the Gramm-Leach-Bliley Act was passed. Congress had learned from the securities and insurance experiences of foreign banks, both the high points and the low points. On the one hand, institutions in some European countries had successfully broadened their securities and insurance activities. On the other hand, there were lingering questions about whether some Pacific rim banks were too closely linked to certain commercial enterprises in the region, thus facilitating the Asian financial crisis of the late 1990s. However, the U.S. banking industry had also developed improved ways to manage risk, and banking supervision had become more effective. In addition, the improved analytical capacity offered by new technology, better coordination among domestic and international bank supervisors, a healthy track record for U.S. banks, and the growth of consolidated home-country supervision across the world helped U.S. banks and their affiliates to further expand their commercial activities.

The response of Congress was essentially threefold. First, it moved the separation wall between banking and commerce to reflect what had already occurred in the marketplace: Gramm-Leach-Bliley also addressed the broader question of what types of businesses could own or affiliate with banks by allowing companies to own banking, securities, and insurance entities within a structure known as a financial holding company. Second, Congress provided a way for banks to gain new-product authority when the new products were determined to be financial in nature, incidental to banking, or complimentary to existing banking authority. Third, by clearly separating the federally insured entity--either banks or thrifts--from the newer and potentially higher-risk new-product authorities, Gramm-Leach-Bliley reaffirmed as a matter of public policy that banks continue to be regarded as special. But the act offers a clear acknowledgment that the separation of banking and commerce is not a bright line but is instead a negotiated compromise--one that will continue to move as markets change and products are refined. The guiding consideration in this compromise will be the protection of the federal deposit insurance fund.

Are banks still special?

Much has changed in the banking landscape since Corrigan wrote his essay twenty-four years ago. Significant increases in international capital flows among bank and nonbank entities, in addition to a broad range of specialized financial instruments mean banks can no longer be considered the only source of transaction accounts. Except for their access to the Federal Reserve discount window, banks are no longer the dominant provider of liquidity for other financial industries. But banks remain the key access point to the dominant wholesale payments network, and they still provide federally insured checking and savings deposits. With the rise of new financial services, products, and techniques, moreover, banks have expanded their role in providing liquidity in more indirect ways, for example, through securitization of loans and backup commitments to securitization vehicles and other capital-markets instruments. Even when banks may not be "special" or unique providers in a particular market, banks have proven themselves to be formidable competitors and innovators--which only reinforces banks' importance in the proper functioning of our financial system. In short, the public's trust and confidence in banking continue to be vital to our financial well-being.

Banks provided considerable credit in the aftermath of the September 11 attacks, when financial flows were slowed by operational problems. To be sure, banks were able to provide this credit in part because of the huge injection of liquidity provided by the Federal Reserve. But that is a key role for banks in a crisis: to obtain funds--through the discount window or from open market operations, if necessary--and to channel them to those needing funds, based on an assessment of their creditworthiness. Banks' access to the discount window and the payments system, as well as their ongoing relationships with customers and their credit-evaluation skills, allow them to play this role. During a crisis, those banks that play critical roles in the payments system are especially important. As a result, these banks are expected to be very resilient. Though banks now have a smaller role in transmitting monetary policy, they still help to transmit policy actions by arbitraging between the federal funds market and other money markets.

Conclusion

A strong case can be made that banks continue to be special. And because they are special, we, as regulators, will continue to apply high standards to companies seeking a bank charter. We must also continue to examine and supervise banks for safety and soundness. Likewise, it appears that Congress will take a cautious approach when determining what types of companies may own and affiliate with banks.

But banks must also compete in the marketplace. Consequently, we can expect over time to see adjustments in both the direct activities of banks and in the line separating banking and commerce. History is, in some sense, about the drawing, re-evaluation, and re-drawing of lines. As a matter of public policy, changes will trail rather than lead the marketplace, and any changes must be informed by a careful study of both the role we want banks to play in our economy and the needs of the marketplace.