The Need for Reform

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THE NEED FOR REFORM

Today, the United States is faced with a largely insolvent thrift industry, a fragile banking system, and a regulatory structure which many, including myself, believe has aggravated the very problems it was intended to solve. The blueprint for our current financial system was drawn up in the 1930s in response to the collapse of the financial sector which was triggered by the Great Depression. Banks were deemed to be "special" and, consequently, were provided with an expanded safety net and a high degree of government regulation. Market forces were supplanted by a web of regulations, restrictions, and federal guarantees.

The continuing conflict between regulation and market forces has reduced the efficiency, stability, and competitiveness of the U.S. financial system. As financial markets continue to evolve, regulatory policies and practices become less effective and the subsidized financial safety net more costly. Under the "arthritic" hand of public policy, banks have lost market share to unregulated providers of financial services. The combination of regulation and the safety net has encouraged banks to take more risks, and the costs of bearing those risks have been transferred to the taxpayer. Clearly, it is time to reassess and revamp the current system of financial regulation.

The goal of financial reform should be to maximize the efficiency and international competitiveness of the U.S. financial system while minimizing the exposure of the federal financial safety net, and hence the U.S. taxpayer. To achieve this goal, I propose narrowing the safety net and reducing government involvement in financial markets. In fact, narrowing the safety net must be a precondition for further deregulation of the banking industry. The degree of safety net reform will dictate the extent to which broader powers can be granted to banks. Market forces should shape the structure and performance of the financial services industry, and market participants should bear the risks of the decisions they make.

This afternoon I will discuss how the web of regulatory taxes and subsidies has hampered U.S. banks' ability to compete in the growing financial services marketplace and how the expanding federal safety net has contributed to instability in financial markets. I will propose reforms to reduce the cost and scope of the financial safety net, paving the way for banks to become more competitive.

Regulation and Its Unintended Results

Lawmakers and regulators have attempted to achieve financial stability by setting up a delicate and complex web of regulatory taxes and subsidies. In the case of banks, lawmakers and regulators have sought stability by prohibiting banks from engaging in certain activities (Glass-Steagall restrictions) and by subsidizing the banks' access to market funding (through federal deposit insurance). Over time, however, market forces have weakened regulations, often making them ineffective, or even counterproductive. These effects are accentuated by exogenous shocks to the financial system, such as surges of inflation and advances in technology.

Not surprisingly, the response of regulators has been to absorb the shocks by adjusting the size and mix of restrictions, taxes, and subsidies. Regulatory changes tend to lag developments in the marketplace and are typically piecemeal, usually with the effect of either validating market innovations or reregulating areas where market forces have made existing regulations obsolete. New regulations may be designed to limit or prohibit activities that are deemed "too risky," such as thrifts' investments in high-yield bonds. Regulations that are unenforceable or politically costly may be removed, such as, deposit-rate ceilings. Other regulations, such as capital standards may be modified.

Essentially, these responses deal only with the symptoms without making the basic structural adjustments necessary to allow the banking system to fully adjust. Often this results in policies aimed at protecting the regulator's weakest client firms at the expense of the efficient firms in the industry and, hence, the stability of the banking system. Moreover, regulatory interventions in the banking system have thwarted market-oriented forces so often that normal market outcomes have become difficult to achieve. Consequently, increased subsidies from the public purse become necessary to support an inefficient financial services industry. While this system may reduce the number of failures in the short term, it increases the loss of efficiency and the public exposure to loss in the long term. The unintended result of regulation is a banking system that is less competitive and less stable in the long run than one governed by market principles.

Erosion of Banks' Market Share

Increased competition from both foreign banks and nonbank providers of financial services has reduced banks' share of the financial services market. For example, banks compete with the financing subsidiaries of General Motors and Ford in the market for car loans, with General Electric and Prudential in the commercial loan market, and with Merrill Lynch and Sears Roebuck in deposit-gathering markets.

Transactions deposits are no longer the exclusive domain of commercial banks, as can be seen by comparing the development of Money Market Mutual Funds (MMMF) to their bank equivalent, Money Market Deposit Accounts (MMDA). Both of these types of accounts grew phenomenally when first introduced about ten years ago. In 1984, MMMFs held $168 billion, while MMDAs held $417 billion. By 1989, the respective numbers had increased to $309 billion and $487 billion. Some other financial institutions also compete with banks here, though less directly. For example, non-term life insurance premiums are comparable to a savings account.

Banks today rely less on ordinary retail deposits and more on "bought money" obtained from the wholesale credit markets. Banks acquire such funds primarily by issuing large CDs. Between 1980 and 1989, CDs outstanding more than doubled, from $256 billion to $541 billion. In this type of liability, banks also face substantial competition from other wholesale credit market participants, though banks are holding their own in a rapidly growing market. For example, between 1980 and 1989, U.S. Treasury bills have increased from $200 billion to $407 billion, and commercial paper outstanding has increased from $124 billion to $529 billion.

On the asset side of the balance sheet, banks and nonbanks compete vigorously. Nonbanks make consumer and commercial loans. For example, GE Financial Services has a commercial loan portfolio second in size only to Citibank's. Among all lending institutions with financial receivables above $3 billion in 1987, nonbanks held 46 percent of all financial receivables and 44 percent of the consumer loans. Banks held the remaining 54 percent and 56 percent of loans in those respective categories. These numbers should not be that surprising: the largest consumer lenders (in order of importance) were General Motors Acceptance Corporation, Citicorp, Ford Motor Credit, and American Express.

In the commercial lending arena, the large nonbank companies extended 48 percent of the commercial loans. For example, Ford Motor Credit makes real estate loans and buys credit card receivables via thrift and finance company subsidiaries. And insurance companies accounted for over half of the commercial loans made by the nonbank lenders of this group.

The development of more active and broader capital markets has enabled corporate borrowers to obtain funds directly from investors without going through a bank. Indeed, looking at the credit market claims against the domestic nonfinancial sector, banks' share has dropped (as has S&Ls') from 33 percent in 1980 to 27 percent in 1989. Bank loans, not including mortgages, dropped from 17 percent of nonfinancial business credit in 1980 to 15 percent in 1989. A more dramatic decline occurred in lending to large corporations, those best able to use the capital markets. From 1975 to 1986, banks' share of the short-term debt of large corporations fell by nearly half, from 50 percent to 27 percent.

This erosion of market share seems to indicate that, though commercial bank lending and deposit-taking has increased since 1980, banks have failed to keep pace with a very active and expanding financial services market. The restrictions on organizational form, geographic location, and business activities, coupled with access to federal deposit guarantees, the Federal Reserve's discount window, and the Federal Reserve-operated payments system have made banks less efficient and less able to adapt to changes in the economy than they would be if they were more subject to market incentives. If current restrictions and regulations and the safety net are not reformed, banks' share of the financial services market will continue to erode.

The Fear of Systemic Risk

The typical rationale for the safety net and restrictions and regulations is to safeguard against financial panic and collapse, that is against systemic risk, by protecting individual depositors and banks . Systemic risk conjures up the image of widespread failures of banks, where one bank failure causes other banks to fail, and so forth. The closure or failure of institutions carries negative connotations, but what does failure actually mean? It does not mean that the physical assets disappear. Rather, the resources of the failed institution are put to more efficient uses. The failure of an individual bank does not automatically result in a cascade of failures. The systemic problem is more one of gaining time and information for the resolution of potential losses than of a vast evaporation of capital through actual losses.

Exposure of the banking system to systemic risk depends on the prudent holdings of cash, liquidity, and capital of each bank. Permitting banks to fail can strengthen the banking system and the nation. The very possibility of failure provides strong incentives to bank management to follow sound banking practices. The economic reorganization, even the liquidation, of a bank prompts the reallocation of scarce labor and property resources to more efficient uses, and removes the need for taxpayer subsidies to prop up the bank.

Rational vs. Irrational Bank Runs: *When examining the issue of systemic risk, a distinction must be made between rational and irrational bank runs. A rational bank run is one that occurs because depositors have information that their depository institution has (or may) become insolvent. This type of run should not be contagious and should not be prevented by regulators. In fact, it is one of the methods the market uses to weed out weak institutions. Because rational bank runs are essentially a market-driven closure rule, they act as a form of market discipline on bank management and shareholders.*

An irrational bank run is one that occurs because poorly informed depositors mistakenly believe that their depository institution has (or may) become insolvent. Institutions that are truly solvent can stop an irrational run by demonstrating their solvency. Although these runs theoretically could be contagious, it is unlikely that they would be (except, possibly, to other insolvent institutions) because other banks and thrifts have incentives to provide liquidity to solvent institutions experiencing runs.

A properly functioning central bank, in its capacity as lender of last resort, can prevent irrational bank runs from becoming systemic runs by providing liquidity to the financial system through open market operations or lending directly to any solvent institution experiencing runs. In doing so, the central bank relieves pressures on solvent institutions and removes any potentially destabilizing effects of irrational bank runs without precluding rational bank runs on insolvent institutions. The Federal Reserve's role in providing liquidity to financial markets during the October 1987 stock market crash illustrates how a properly functioning central bank can prevent spillover effects to the overall economy from crises in financial markets without propping up individual institutions.

The Payments System: *The second source of systemic risk is related to the effects of a bank failure on the payments system. Because banks are the conduit for payments in this country, some people fear that the failure of a major depository institution could cause the failures of other banks connected to the payments system, topple the payments system itself, or at least shut it down for an unacceptable period of time. However, there is no reason that the failure of any institution, let alone a large one, should result in the collapse of the payments system.*

Even today, the loss on assets associated with large bank failures is typically small, certainly not approaching 100 percent. Therefore, banks with payments-related exposure to the failed institution should realize only a small loss, and the threat of loss from payments-system defaults should cause banks to limit their exposure to other banks that are considered to be excessively risky. Participants in the payment system can protect themselves against the risk of adverse developments by estimating and controlling their susceptibility to potential failures of their counterparties. They should be encouraged to do so by the knowledge that policymakers will protect financial system liquidity but not individual institutions.

The myth that exposure to systemic risk can only be controlled by government intervention is debunked by the extensive private clearinghouse and other private contractual arrangements. In the past, these arrangements seem to have been successful in managing risk exposures among interdependent counterparties. After all, banks routinely do this today in the federal funds market and similar measures have been adopted by the Clearing House Interbank Payment System (CHIPS). This electronic foreign exchange payments network, operated by the New York Clearinghouse, handles volume of payments rivaling Fedwire funds transfers. This past October, CHIPS implemented an agreement for loss-sharing, with a $4 billion pool of participants' liquid collateral to back that agreement.

The crucial feature of any private arrangement must be a contractual agreement placing risk of loss squarely on the parties to the arrangement. Consequently, participants have an incentive to monitor the creditworthiness of their counterparties and enforce standards that limit the risk being assumed.

Some of the underlying financial market transactions that now generate payments may no longer be feasible because private parties will not be willing to assume the risks of failure to which they would be exposed on terms acceptable to the transacting parties. In addition, the lender of last resort can immunize the rest of the payments system from the failure of a single bank by lending (with a "haircut") to banks against their claims on the failed institution until those claims are realized. Furthermore, as I mentioned earlier, systemwide liquidity needs arising from the failure of a large bank could be addressed through the Federal Reserve's Open Market Desk.

In short, systemic risk, properly viewed, is not a catastrophic problem, unless the misguided efforts to protect against systemic risk diminish proper private-sector provision against risk. In my view, that is close to being the case in the United States. For the past two decades, the safety net has been substituted for private capital and liquidity. The safety net is perverse because it undermines the very essence of financial exchange -- counterparty scrutiny. In the absence of the safety net, managers of banks would maintain larger cushions in the form of cash, liquidity, and capital, raising the threshold of payments gridlock, and electronic bank runs, and reducing interbank exposures. Moreover, private risk-control measures would be developed and adopted as bank managers seek to deal with failures in an orderly way.

Safety Net Reform and Increased Market Discipline

The current system of regulations and restrictions along with the expanded safety net have reduced the competitiveness of the banking system and have contributed to instability in financial markets. The alternative to continuing down this path is to reduce the federal safety net and increase market discipline by having debt and equity holders of banks act as a constraint on management's risk-taking behavior. Under this approach, bank management would decide what financial activities to engage in, what type of products to offer, and what organizational form to adopt. The end result would be a more efficient and competitive banking system that does not depend on government subsidies to survive.

To achieve this result, I advocate the adoption of a four-part package of reforms. The essential elements in my reform package are: 1) reforming the deposit insurance system; 2) restraining the discretion of regulators to transfer risk from the private to the public sector by adopting mandatory closure rules; 3) providing the public with better information; and, 4) separating the insurance and supervisory functions of the FDIC. These reforms would reestablish the market as an additional source of discipline on the behavior of insured depository institutions and thereby increase the effectiveness of, and reduce the need for, government supervision. In addition, by returning risk-bearing to the private sector, these reforms will lead to an increase in capital at those banks holding risky portfolios.

One caveat to note is that the reforms I propose cannot be adopted overnight. A phase-in period will be required. This is especially true of deposit-insurance reforms. A transition period is required to recapitalize, reorganize, or close insolvent and unsound institutions. But a successful transition will require decisions, up front, to limit the safety net. Although these transitional costs may complicate the reform process, they should not be allowed to delay it. As we have seen with the thrift crisis, the longer the delay in dealing with the costs, the larger the costs become.

Reforming the Deposit Insurance System

Key to any market-oriented system is extensive reform of federal deposit insurance. The degree to which fundamental reforms to federal deposit insurance are implemented will determine the nature and scope of reforms to the remaining regulatory structure. Restoring market discipline as an effective constraint on bank and thrift activities should be the key objective of deposit insurance reform. This entails changing the coverage and pricing of deposit insurance to eliminate or reduce the degree to which the taxpayer subsidizes risk-taking by financial institutions.

An unintended side effect of deposit insurance has been to make managers and shareholders less responsive to market incentives and to redirect the flow of capital and market funds away from well-managed institutions toward poorly managed ones. This system most assuredly resulted in fewer bank failures from the mid-1930s through the late 1970s, but did so at the expense of the long-run stability of the financial system, as evidenced by the escalation of problems in the banking and thrift industries in the 1980s. Reduced access to capital and funds by marginal firms in a market setting would have been an important self-correcting force that would have helped achieve long-run stability in our banking system.

To restore proper discipline to an institution's shareholders and managers, federal deposit insurance coverage must be limited. At the very least, the current statutory limit of $100,000 per insured deposit account at each insured institution should be strictly observed. Deposit insurance coverage must not be extended in any circumstance to uninsured depositors, unsecured creditors, and stockholders.

To truly reap the benefits of deposit-insurance reform, the current limit should be reduced, and coinsurance should be made available for coverage on balances that exceed the limit. Deposit insurance should provide a certain amount of protection to small depositors. Such protection would be quite consistent with market discipline, reduced subsidies to regulated firms, and reduced liability for taxpayers. It should not be used to provide competitive advantages to one class of providers of financial services. As policymakers consider the appropriate maximum level of deposit insurance coverage, they should keep in mind that the original $2,500 limit, adjusted for inflation, is roughly $25,000 today. Moreover, the average insured deposit account in banks is $12,000; and in thrifts it is $8,500.

Survey evidence compiled by the Federal Reserve Board of Governors suggests that only 1.4 percent of American families would be affected by a lowering of the ceiling below $100,000, and that these families could exert a high degree of discipline on the banking system because they control over 28 percent of total bank deposits. According to private estimates, 98 percent of deposit accounts are less than $40,000 and of these accounts, the median account is less than $3,000.

In addition to lowering the insured deposit ceiling, a coinsurance feature should be added for additional deposit balances above the $25,000 per depositor, full-insurance level. Coinsurance was a feature of the original (1933) interim deposit insurance program. I propose that the Federal Deposit Insurance Corporation (FDIC) provide 90 percent coverage for balances between $25,000 and $50,000, and 70 percent coverage for balances in excess of $50,000.

An important feature of coinsurance is that it would establish minimum recoveries on deposit balances in excess of the fully insured limit. This would remove an important constraint on the FDIC's ability to resolve bank failures quickly without extending forbearance to uninsured depositors. With coinsurance, the federal deposit guarantor would not need to estimate in advance losses to the uninsured depositors; rather, the coinsurance haircut would be applied to depositors' balances. If the institution's total losses did not exceed the haircut amount, the receiver would rebate to the uninsured depositors their share of the difference. Thus, coinsurance would alleviate financial hardship for uninsured depositors by paying them a predetermined portion of their deposits up front.

The strict enforcement of any deposit insurance limit requires some changes to the failure-resolution policies of the FDIC, including statutory constraints on the authority of the FDIC to rescue large insolvent financial institutions. These constraints would preclude the use of failure-resolution techniques such as open-bank assistance and purchase-and-assumption transactions, which provide de facto coverage to uninsured claimants.

The Role of Private Insurance: *Private insurance could play a role in the above proposal if the statutory limits on federal coverage are strictly adhered to and there is a well-defined closure policy. Under these conditions, private insurers could step in and provide coverage for the coinsurance deductible portions of the federal coverage. Presumably, the insurance would be offered to depositors through their bank. Private deposit insurers would have to be well-capitalized and operate their insurance funds in an actuarially sound manner.*

Private insurers should be given access to examination reports and must have the right to conduct their own periodic audits of privately insured depository institutions. Furthermore, they must have the right to cancel their coverage with a 60-day notice for existing deposit balances, and to implement immediate cancellation for new deposits or additions to deposit balances. Note that small depositors would enjoy full protection by the FDIC so they would not be materially affected by the cancellation rights of the private insurer.

Risk-based Premiums: *Congress should require that the FDIC adopt a risk-based deposit insurance premium schedule for banks and thrifts. Currently, there are several proposals that outline methods for doing this. Each has its merits and its problems. However, the method selected for doing this should tie the deposit insurance premium as closely as possible to the risk premium the market would assess.*

Adopting Mandatory Closure Rules

The current failure-resolution policies of the FDIC encourage risk-taking by large banks and create competitive inequities for smaller banks. When regulators

seek to minimize insured deposit payouts by allowing insolvent banks to remain open, uninsured claimants are protected by extension. This practice eventually allows banks to evade the market discipline of failure and, as we are seeing now, greatly increases long-term exposure to both insured and uninsured claims.

Rules dictating the terms and conditions under which bank regulators intervene must be adopted. The approach I advocate is one of early and active intervention. Under this approach, regulators would be assigned the task of enforcing a few basic rules (for example, minimum capital requirements, periodic reporting and public disclosure requirements, outside audits, and market-value accounting), and monitoring efforts would be directed at ensuring that those rules were observed. As bank's capital levels decline, mandatory supervisory actions would be required. Weak, but generally sound banks would be subject to limitations on expansion and on activities which reduce capital. Bank management would be required to submit plans to increase capital. Thinly capitalized banks would be prohibited from expanding and would be required to restore capital. Owners of banks falling below the minimum capital adequacy guidelines would be given the option to immediately recapitalize the bank or surrender it to the government for sale or liquidation. Banks, regardless of size, determined to be insolvent would be immediately taken into receivership for government sale or liquidation. Any profits from the sale or liquidation of depository institutions would be rebated back to the original owners.

I suggest that the minimum capital level required to operate a bank be market-value equity equal to three percent of total assets. Given the reduction in explicit and implicit deposit insurance coverage, the amount of capital held by banks in excess of the regulatory minimum would be determined by the market. After adjustment to the reforms, it would certainly be in excess of regulatory minimums.

This mandatory closure policy would minimize the exposure of the deposit insurance fund and would restore market discipline. Under this policy, no institution is "too big to fail" and deposit insurance guarantees would not be extended to uninsured depositors or unsecured creditors of banks. The systemic risk impacts raised by such a policy can be managed over time. Early intervention will reduce the threat of systemic risk because an institution will be closed while it is still solvent and before depositors are at risk.

As I mentioned earlier, by effectively carrying out its lender of last resort function (providing liquidity to the financial system through open market operations or lending directly to a solvent institution), the Federal Reserve can also contain risks stemming from contagious deposit runs. However, providing liquidity to a non-viable institution where no immediate resolution plan is in place is tantamount to regulatory forbearance. Therefore, a critical element of an effective early intervention program is an explicitly stated policy that the Federal Reserve will not lend to an insolvent or non-viable institution.

Providing the Public with Better Information

Under the current deposit insurance system, information about the condition of an institution is not in demand by depositors. Instead, depositors are interested in finding insured institutions offering the highest rates on deposits. If large depositors were at risk when an institution failed, the depositor would certainly be interested in the financial condition of the institution. Information on the condition of institutions would become more important than information on deposit rates.

Central to increased market discipline in the banking industry is the timely dissemination of information. Savers and investors should be provided with adequate information for decisionmaking. The regulatory community can improve the information available to markets by moving from the suppression of information to its timely dissemination. FIRREA takes an important step in this direction as it mandates that cease-and-desist orders, supervisory agreements, and other regulatory actions are to be published by the appropriate supervisory agency. However, I would go even further and advocate that banks and thrifts should have the right to release their examination ratings and reports to the public. In addition, annual audits by independent accounting firms should be required for all financial institutions and the results of these audits should be made public. For small, well-capitalized institutions for whom this rule could prove to be a financial hardship (for example, consolidated entities with less than $100 million in assets), outside audits could be required only every second or third year.

I also propose the use of market-value accounting. At the very least, banks and thrifts should be required to file a regulatory net worth statement based on market-value accounting in addition to the quarterly reports of condition and income they currently file with the federal bank regulators, and closure rules should be based on the market value of capital.

Traditional accounting systems like GAAP (generally accepted accounting principles) and RAP (regulatory accounting principles) result in unnecessary noise in the information system because they allow firms to carry assets and liabilities at their par value (usually, historical cost) and do not reflect the subsequent changes

in their market value. Therefore, GAAP and RAP may not be good measures of the true solvency of a bank or thrift. To make matters worse, both GAAP and RAP tend to be high-biased measures of solvency for banks and thrifts experiencing solvency problems, and the degree of error in GAAP and RAP measures increases as solvency deteriorates.

Critics of market-value accounting correctly point out that market-value accounting systems themselves are not perfect, as there are many assets and liabilities on the balance sheets of banks and thrifts for which estimates of market value are not readily available. However, it is possible to adjust asset and liability values for changes in interest rates and, as markets develop for securitized bank assets, the ability to make reasonable, market-based adjustments to the value of similar assets in bank portfolios increases. I want to emphasize that market-value accounting should apply to both assets and liabilities. It does not make sense to apply market-value accounting to only the asset side of the balance sheet. These adjustments should be made as a first step toward full market-value accounting. Note that the Comptroller of the Currency's new nonperforming-performing loan distinction is essentially a mark-to-market rule. All new activities authorized for banks and bank holding companies should be booked on a marked-to-market basis.

Market-value accounting is not a panacea and still results in noisy information streams. Nonetheless, it is a less-noisy information stream than the one that flows from both GAAP and RAP. Over time, market-value accounting should become less noisy as financial markets evolve.

Separating the Insurance and Supervisory Functions

My final proposed reform is to separate the insurance and the supervisory functions. This separation is necessary to ensure free exit from the industry and to provide a check on regulatory forbearance. By separating the insurance function from the supervisory function, we remove possible conflicts of interest between those functions. For example, the deposit insurer could adopt a policy of capital forbearance to cover up supervisory errors.

As an insurer, the deposit-insurance agency seeks to maintain the value of its insurance fund. The deposit insurer would monitor and audit the insured industry as a means for collecting information on the risks posed to the fund by individual depository institutions. Through its pricing decisions and its power to terminate or limit insurance for banks and thrifts that are being operated in an unsafe and unsound manner, the deposit insurer can force the primary regulator to take corrective action or force the closing of an unsafe or unsound institution. The deposit insurer could even factor into its premium-pricing decisions the loss experience associated with each regulator, thereby establishing a pseudo-market price for regulatory services.

In addition to eliminating the deposit insurer's supervisory responsibilities, using the deposit insurance function as a check on overly permissive supervisory and regulatory forbearance policies requires some basic changes. First, the deposit insurer must have the right to terminate insurance coverage immediately for new deposits (or new additions to old deposits above the accrual of interest) when it determines that an institution is being operated in an unsafe and unsound

manner. Second, it must be able to charge differential premiums to institutions based on risk, including regulator risk. Third, the insurance and receivership functions should be separated. Splitting the receivership function into a separate agency would remove the incentive for the deposit insurer to forbear by extending implicit coverage to uninsured claimants or to take on contingent liabilities in order to minimize short-run failure-resolution costs.

Conclusion

Financial services industry reform has reached a crossroads. The current system of regulatory taxes and subsidies is unworkable and, as evidenced by the enormous and growing price tag for resolving the thrift crisis, it has proved to be very costly. It is time for us to make a choice between a regulatory structure that relies more heavily on markets or one that relies on bureaucratic rules and political judgments. For me the choice is clear. If we want to have an efficient and stable financial system and want to avoid FSLIC-type bailouts in the future, we must choose a market-oriented solution.

The set of reforms I have proposed would reduce the cost and the scope of the financial safety net and thus, serve to reduce the socialization of risk and reestablish the market as an important part of the financial institution oversight process. Rather than blocking or attempting to circumvent market forces, these reforms would rely on market forces to reestablish the risk-return trade-off in financial services, so that those who benefit from the upside gains of risky strategies would also bear the down-side losses when these strategies did not pan out.

With adequate safety net reforms in place, we can embark on a path of deregulation that would allow financial services providers a free hand in choosing what products to deliver, where to deliver them, and how to deliver them. The end result will be a more efficient, competitive, and stable financial system that will not need to rely on taxpayer subsidies to compete, or even survive, in the increasingly global marketplace.

What do we do if safety net reforms are not adopted? The answer is simple. Banks do not get new powers, and regulations on banks are tightened. We will see a continued erosion of banks' market share. Ultimately, we will see a restoration of an unregulated competitive financial services industry as banks disappear from the marketplace. This is not my preferred alternative. The need for reform is clear and the time to act is now. Congress should phase in appropriate reductions in the federal safety net and free the banks to compete.