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BANKING REGULATION AND DEREGULATION

Remarks by

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I am pleased to have the opportunity to participate in this examination of the evolving American financial system. In my remarks this morning I will be focusing on the role of the Federal Reserve System as a bank regulator, rather than on the System's role in monetary policy. Clearly, however, we must recognize that there is a close relationship between the two functions, because an effective monetary policy depends on a sound banking system.

As regulators, we are caught in the middle on many key issues, with technological change and competitive innovation making regulations and statutes harder to justify and enforce. The circumstances are in many ways reminiscent of the situation in 1979, when interest rate ceilings on deposits were being widely evaded. Fortunately, Congress took steps to deregulate these rates, using a phased deregulation approach. The phase-out of ceilings on deposit interest rates may offer a successful model for future procompetitive regulatory initiatives.

Today, we see an analogous erosion of the regulatory barriers that have limited interstate banking and created boundaries between banks and other financial institutions. Many restrictions are no longer effective in serving their intended purpose, yet they remain strong enough to distort competition and limit the benefits of innovation. Rather than referring to regulatory barriers, one might say that what we have now are regulatory speed bumps: they are sufficient to create a nuisance, but they do not really stop market participants from getting to where they want to go.

The traditional regulations need to be reexamined to determine which are essential to the safety and soundness of the financial system. Those that are ineffective or which serve only to inhibit competition should be weeded out. For example, can we argue that prohibiting a bank from operating a branch within its own community is necessary for the safety and solvency of that bank, or any other bank in the community? Clearly, there is no evidence to justify restrictions of this type. Yet, a number of states still maintain very strict limitations on branch office locations. Indeed, in the case of Texas, enactment of proposals to allow expanded branch banking will require an amendment to the state's constitution.

In evaluating the existing regulations, I want to underline my own strongly held view that we should seek a regulatory system that will provide the maximum role for the operation of the market system. We all recognize that the free market system is the best method yet devised for achieving an efficient and innovative financial system. Thus, we want to allow the forces of competition to have the maximum possible role in the design of the financial system.

In examining the limits of the market system as a regulator of the financial system, we can identify two types of risk that are not adequately controlled by the market. The first is systemic risk, the risk that the failure of one or a few institutions will result in a spreading panic and the collapse of other institutions. We have seen the impact of bank runs throughout American history, and we know that in a panic there is no discrimination between the conservatively-run sound institution and the speculatively-operated unsound institution. Both are swept away.

Events in Ohio and Maryland last year demonstrated once again the consequences of a loss of confidence in a large group of institutions. We learned that, even though half a century had elapsed since the nation last experienced widespread bank runs, people's basic behavior has not changed: when their savings and transaction balances are threatened, they line up to withdraw their funds. In addition, we learned that the public will not maintain its faith in an insurance system that is not adequately funded and able to respond immediately to emergencies.

Having experienced the economic damage and the personal hardships resulting from the systemic failure of large numbers of depository institutions in the 1930s and recognizing from recent experience that the underlying risk still remains, we must stand firm in our resolve to prevent widespread bank failures. Deregulation should proceed in such a way as to not significantly increase the risk of systemic failure.

The institution of federal deposit insurance in the 1930s, while reducing the risk of systemic failure, introduced a second risk, known as moral hazard. The incentive to protect against a hazard is less for those who have insurance than for those who do not have insurance against that hazard. In the case of deposit insurance, a moral hazard risk exists because depositors, being insured by the government, have no incentive to constrain the risk-taking behavior of financial institutions. If many depositors stood to lose by putting their funds in high-risk banks, the limits of their willingness to accept risk would tend to constrain bank behavior.

Under the present system of deposit insurance, however, most depositors have no concern as long as their balance is within insurance limitations. The experiences of the 1980s suggest that large depositors are becoming increasingly careful in monitoring financial institutions and that they are exerting some market discipline. The banking agencies, however, remain as the major monitors of bank risk, just as casualty insurance companies must seek to monitor and constrain the risks taken by their clients.

The systemic and moral hazard risks to the banking system suggest that the major objective of bank regulation should be the prevention of excessive risk-taking. Even the government's deposit insurance fund would not be adequate to deal with the losses that could result from the total lack of restrictions on risk. Except for controls on risk-taking, we should permit competitive market forces to guide the development of the financial system. Even in those cases where regulations are essential, we should attempt to devise regulatory frameworks that are based on market type incentives.

Thus far, the deregulation that has occurred does not appear to have resulted in a great increase in banking system risk. Let me look briefly at the risk implications of some forms of deregulation. First, we have experienced a nearly total deregulation of interest rates paid on deposits. Contrary to the fears that were expressed in the past about the dangers of letting institutions compete for funds, there have been no reports of excessive rate competition resulting in failures. There have been some reports that those thrift institutions that are operating in spite of their insolvency are paying above market interest rates in order to retain their deposit base and be more attractive acquisition candidates. These problems, however, are not a result of competition, but rather are a consequence of the inability to resolve all of the failed thrift problems in a timely manner.

Geographic deregulation also is proceeding at a surprisingly rapid rate even though there has been no change in federal law. Most states have made very significant progress in enabling banks and bank holding companies to expand the geographic scope of their operations. The barriers of the past, which in too many cases restricted competition by preventing the entry of new competitors, are gradually being reduced.

Only 14 states have not yet enacted interstate banking bills. While most of the laws have provided for regional, rather than nationwide, interstate banking, it is encouraging to note that 18 states have statutes providing for current or future entry from all other states. Given that none of the states had any general provisions for entry by out-of-state banking organizations until 1975, this is indeed quite an amazing amount of deregulation.

As yet, no increased risk is apparent from the interstate expansion that has occurred. While some risks may be associated with beginning lending operations in new geographic markets, most of the interstate expansion thus far has been via acquisition. Thus, the lending expertise of the acquired firm is available to the out-of-state firm and this type of risk is decreased. In the long run, our hope would be that better geographic diversification in loan portfolios would tend to reduce risks for individual institutions and to promote the overall soundness of the banking system.

The regulation of capital also serves to control the risk that overly rapid expansion would endanger the operations of the firm, although it is difficult for both bankers and supervisors to determine an adequate level of capital given the problems of forecasting future loan losses or sources of risk. As long as we ensure that interstate mergers do not result in a weakening of the capital ratios of the merged organization, an adequate capital cushion generally should be available to absorb any losses that do occur and to maintain public confidence in the institution.

Turning to bank product expansion as a third form of deregulation, we find that this area contains the greatest potential for added risk exposure. I strongly believe that depository institutions need to be able to expand their product offerings in order to compete with other segments of the financial industry. Ultimately, I would hope that banks and bank holding companies would be full-line providers of financial services. Indeed, I think that this expansion of services is required in order to preserve the role of the banking system in the economy and to maintain a sound and resilient financial structure.

While product expansion is necessary and will be achieved in the long run, there will be some risk exposure involved as banks offer new and less familiar products and services. Some new offerings may lower the combined risk exposure level of the financial firm, but others will increase that exposure. For there to be a reduction of risk to the bank, new products must lower the average risk or the variance of returns. Moreover, while we can examine the historical record of the firms currently offering a particular service and calculate the average return and the variance of that return, we cannot be sure that these same results will be achieved when this service is offered by commercial banks.

Given the banking industry's uneven past record with respect to expanded product offerings, we should proceed with some caution, but proceed we must. If we do not move ahead, we will find that banking organizations will be even more seriously handicapped in their competition with other financial service providers. Loss of competitiveness in turn would be a source of risk for the depository system.

On net, therefore, I do not believe that current or proposed levels of product line expansion have increased the need for the regulation of risk-taking by financial institutions. Obviously, however, we must continue to be careful in the future steps that we take. For the level of regulation that continues to be necessary, we must consider the extent of the risks involved and design a regulatory system appropriate to those risks. The supervisors are going to have to review depository institutions on a case-by-case basis for outliers. Indeed, more deregulation of bank powers may create the need for more supervision.

While there may be a role for product line regulation in protecting the safety and soundness of banking institutions, I am convinced that the best approach to these issues is to provide banks with a broad incentive structure that rewards sound practices. Policies that work in this direction are risk-based capital requirements and risk-based premiums for deposit insurance. In addition, careful and effective supervision can serve to reduce the scope for unwarranted risk-taking and to prevent bank failures due to fraudulent or flagrantly unsound practices.

Both the FDIC and the FSLIC have asked for legislative authority to charge insurance premiums that increase with an institution's risk exposure. In theory, such a system would shift more of the costs resulting from risk-taking to those institutions that are taking the biggest risks. This would promote equity because risky banks would no longer be subsidized by safe banks or by the federal insurance agencies.

Another apparent benefit of risk-based deposit insurance is that the link between premiums and risk would serve as a deterrent to excessive risk-taking. Institutions would have an incentive to moderate risk in order to reduce their insurance premium.

While the theoretical benefits of risk-based deposit insurance are widely recognized, whether such a system is practical remains unclear.

One must have accurate measures of bank risk in order to implement the system fairly. Moreover, these measures must be timely in order for the incentive mechanism to work properly: charging a higher premium because a bank's loan portfolio has gone sour may be like closing the barn door after the horse has been stolen. The insurance premium instead must be based on the potential for risk implied by the bank's portfolio behavior. Even if timely, no observer can be sure how much of a premium increase is necessary, how fast the increase will be passed on to depositors, and how fast both the institution and the depositors will react to the new set of market incentives. As these practical issues continue to be studied, some limited experiments with risk-based deposit insurance may be worth attempting.

Another approach to dealing with bank risk is through capital requirements. The FDIC and the Federal Reserve Board, in fact, have taken actions to raise banks' capital requirements modestly and to increase the fraction of overall capital requirements that can be met by subordinated debt. These steps serve to increase the cushion between the value of a bank's assets and its liquid liabilities; moreover, by increasing the importance to the bank of funds which are not insured, higher capital standards serve to increase the extent to which market discipline is brought to bear on the bank's risk choices.

Just as flat-rate deposit insurance is flawed from the standpoint of equity and efficiency, a uniform capital standard may not be appropriate. This past January the Federal Reserve Board put out for comment a proposal that would allow a bank's required capital ratio to vary with a measure of its risk exposure. Our proposal has several objectives. We want to attempt to take account of off-balance sheet activities, which have expanded rapidly in recent years. Moreover, as bank powers are expanded, we may need to broaden our formal measures of risk exposure to include these expanded activities as well. Another goal is to increase the incentives for holding low risk assets. Also, our proposal would bring U.S. capital adequacy policies more closely in line with those of other major industrial countries. Finally, it would provide more explicit guidance to bankers and examiners for relating capital to risk profiles. The FDIC and the Comptroller have made similar capital proposals, and the Board currently is working with those two agencies to develop a common approach for implementing risk-based capital requirements.

At the time that we issued our proposal on risk-based capital, the Board emphasized that the use of a risk-based capital measure would not lessen the need for supervisors ultimately to make judgments regarding an institution's capital adequacy. On the contrary, as I have noted, the role of bank supervision in the overall regulatory process has become more important recently and will continue to do so as bank product offerings are expanded. Because of the increased number of bank failures and problem banks, the Federal Reserve currently is beefing up its supervisory staff, increasing the frequency of bank examinations, and improving the communication of examination findings to bank management and boards of directors. I am pleased to note that other agencies also, within today's environment of budgetary stringency, are attempting to enhance their supervisory and examination efforts.

The bank supervisor or examiner performs two vital functions. One is the monitoring of the bank and holding company's risk and its observance of regulations. Clearly, a bank's risk can only be controlled if it can be monitored; therefore, any attempt to implement risk-based insurance or risk-based capital assumes that the supervisory function is performed carefully.

A second function of supervision is to provide flexibility in the application of rules. This allows the regulatory agency to be more effective in maintaining an individual bank's soundness and gives directors and management more decision-making freedom than would be possible by total reliance on the book of regulations. Recently, we have seen specific examples illustrating the value of this discretionary use of supervisory authority in response to the problems in the farm and energy sectors. In these cases, bank regulatory agencies have adopted supervisory policies to assist basically sound, well-managed banks to weather these economic storms.

The examples that I have just outlined are indicative of how the Federal Reserve Board as a regulatory agency is attempting to cope with today's complex financial environment. Our overall objective is to allow the forces of the free market as much scope as possible to operate while maintaining the safety and soundness of our banking system. However, it is a challenge to keep this goal in focus as we contend with the constraints imposed by statutory requirements, technological innovation, and new developments in the competitive environment.

We await action from Congress on a number of key subjects, including risk-based deposit insurance, the definition of a bank, expanded powers, the long-run role for interstate banking, and regulatory streamlining and reform. Despite widespread acknowledgement that many of our laws are outdated in these areas, change is not yet forthcoming. The reality that we face is that although Congress can leave federal banking statutes frozen in a state of suspended animation, it cannot freeze the state of technology or the forces of competition. As regulators, we find it increasingly difficult to reconcile the dynamics of the changing market place with the static legislative environment. I mentioned at the beginning of my remarks the case of deposit interest deregulation as an area where we were able to make the successful transition from an unworkable regulatory morass to a market-oriented, competitive solution. I hope that we will see a similar resolution to the set of critical issues now facing us all.