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Innovation and Deregulation in Financial Markets in the United States

Presentation by

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Board of Governors of the Federal Reserve System

at the

Federation of Bankers Associations of Japan

Tokyo, Japan

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Over the past five years or so, substantial progress has been made in deregulating the financial system in the United States. Many of you presently are dealing with the effects of similar developments in your own country. It therefore seems appropriate to discuss some of the lessons that can be learned from the deregulation in the United States. There are many aspects to this issue. The Federal Reserve, for example, has devoted considerable energy to dealing with the uncertainties raised for monetary policy by the deregulation of deposit instruments and interest rates. However, today I plan to devote my attention to an issue closer to your own particular interest--lessons for depository institutions from the deregulation of a major financial system.

Recent Deregulatory Actions

Deregulation in the U.S. was stimulated by a variety of market developments that had caused problems for domestic finance. These developments included innovations in unregulated portions of the private sector, and changes in the inflation and interest-rate environment in the United States. Artificial limits on deposit rates had disrupted market processes as market interest rates rose and became more volatile. Furthermore, the combination of market interest rate developments and private market innovations had made life difficult for institutions that were limited to raising funds in regulated deposit markets.

A major thrust of the deregulatory process has been to remove artificial constraints on both loan and deposit rates, to broaden the asset powers of depository institutions that traditionally have specialized in mortgage investment, to remove barriers to investment in mortgage instruments by private investors with diversified portfolios (such as pension funds), and to widen and deepen secondary market channels that can carry loan instruments from traditional lenders to a broad range of capital market investors. These developments reflect confidence by the regulatory authorities in the ability of a flexible private market system to provide adequate credit, at all stages of the business cycle, and at competitive market interest rates.

Fixed ceilings on deposit interest rates have been dismantled in a series of steps since 1978 to permit depository institutions to compete more effectively for funds against unregulated market instruments, such as stockbrokers' money market mutual funds. Only minor remnants of deposit-rate ceilings exist at this time. State ceilings on home mortgage rates were preempted by federal law in 1980 as record high market rates prevented mortgage borrowers from competing effectively for funds in various geographic areas. Maximum interest rates on home loans insured by the Federal Housing Administration were eliminated by federal law in 1983 in an environment of heightened interest rate volatility. Regulations governing investment by private pension funds in mortgage-backed securities have been liberalized since 1981, in order to remove various technical impediments to acquisitions of mortgage-related instruments by fund managers.

In the United States, pricing of depository institutions' deposit structure was gradually changed from regulated pricing to a market determined system, before very much consideration was given to the deregulation of the asset side of institutions' balance sheets. This affected the financial condition of many banks and savings and loans, in some instances producing a significant shrinkage in the spread of asset yields over deposit rates, and in others produced a negative interest-rate spread. The combination of a fixed-rate loan portfolio and a partially deregulated deposit base resulted in difficulties for institutions for an extended period of adjustment. Regulators have responded by permitting broader asset powers. However, many savings and loans were not prepared to take advantage of these new earnings opportunities. Time is required to fully use the opportunities afforded by deregulation.

Further, deregulation raises the question of how high an institution's capital must be to compensate for the new risks introduced by deregulation. While regulators liberalized rules regarding intra- and interstate competition to enhance the consolidation of the savings and loan industry, this liberalization was not enough to eliminate financial institution needs to build up capital, and simultaneously in some cases, liquidity. The consolidation of the banking and the savings and loan industry in the United States is continuing. Financial managers who choose not to be part of the deregulation process can merge into institution's choosing to compete.

A major source of needed capital in the U.S. has been the sale of common stock, including shares issued in the process of converting from the mutual form of organization to the stockholder form. Of course institutions have subsequently augmented capital by issuing large new blocs of equity securities, in both the stock and the convertible debt form. In addition, institutions have been set free to acquire firms both directly as subsidiaries and via utilization of the holding company device, thus becoming affiliated with companies having substantial capital resources. With deregulation comes diversity of activities, and with diversity comes risk. Risk exposure in turn takes on added dimensions when the economy is evolving into one characterized by more volatile interest rates.

On the government side, deregulation demands more informed and more vigorous examination and supervision. However, we all know that the real burden of dealing with change and of seizing opportunity lies with management. Interest rate fluctuations and increasing sophistication among depositors inherently are part of the deregulated environment. Where those forces are coupled with management's need to rely upon short-term deposits, as in the United States, the presence of an extensive secondary market and/or major institutions supporting that market is a must. When very substantial liquidity demands are made on the larger thrift institutions, their very survival may depend upon the ability to sell, swap, and borrow against a newly liquid asset from a marketable mortgage portfolio.

U.S. monetary policy presently is designed to permit the economy to expand toward a full-employment level without regenerating inflationary pressures. This eventually should lead to real interest rates that are lower and more stable than at present, with attendant benefits for other credit-dependent private sectors. The chances of this result being realized would be enhanced by a proper coordination between monetary and fiscal policy. But as you know, the prospect of continued large federal budget deficits in the U.S. still looms ahead. That expectation is widely held in the U.S. financial markets and by the public at large, and the prospect of public sector "crowding out" of private demands for the available supply of credit appears at least partly responsible for the stubbornly high "real" interest rates that have prevailed on longer-term instruments. There are fears in the marketplace that large deficits will not only place heavy demands on the credit markets, but that they will thereby create pressures for excessive monetary expansion, causing the battle to keep the inflation rate under control to become considerably more difficult. These imbalances, occurring as they have during the period of deregulation, have not made the adjustments of depository institutions any easier.

The Internationalization of Financial Markets

The internationalization of financial markets is one of the most important trends that institutions must learn to deal with, and one that shows the high degree of innovation that currently is taking place in financial institutions and markets. Of course, capital has been flowing across international borders for centuries. The economic development of the United States from the colonial period through the 19th century, for example, was financed in good part by capital provided by Great Britain and other European nations. And throughout most of the 20th century--indeed, generally until the current decade--the United States has been a major source of net capital for many other countries. Of course more recently the U.S. has once again become a net user of capital, and has received a substantial share from Japan.

However, during the past 20 years, financial markets in major countries have become increasingly more international in character and increasingly more integrated. Initially this process occurred primarily in the more traditional types of banking activities. Until the mid-1960s, U.S. and foreign banks conducted the great bulk of their international banking transactions from offices in their home countries. At that time, under the impetus provided by the United States program to control capital outflows, banking transactions in dollars outside the United States expanded rapidly. U.S. banks developed foreign branch networks to accept deposits from and extend credits to foreign customers. Initially, the growth of this business occurred principally in offices in Europe--hence, the name Eurodollar market. But soon such international banking activity developed in a wide range of other financial centers, such as Singapore and Hong Kong, and also in newly established offshore banking centers in the Caribbean and elsewhere. And the number of participants grew to include major banks from all countries.

The volume of deposits placed in offshore offices of U.S. banks increased greatly in those days because they were not subject to the U.S. interest rate ceilings or the reserve requirements that applied to deposits in national markets. Over the same time, the rapid development of communications technology helped to enlarge the competitive environment for international financial services to a worldwide basis. In this environment, banks began to shave margins between rates paid on deposits and rates charged on loans, to develop new types of banking instruments, and (later, when U.S. banking supervisors began to require banks to improve their capital positions) to seek income from providing services outside the traditional banking role of intermediation.

U.S. banks have expanded their provision of financial services internationally by playing an important role in the establishment and development of the Eurobond market and by helping to link that market with domestic securities markets. The Eurobond market developed in parallel with the Eurobanking market, although, until recently, at a more moderate pace. Prior to the development of this market, international security issues took the form of bonds issued by nonresidents in national markets and were subject to the regulations that applied in that market. By the mid-1960s, however, the "offshore" Eurobond market had begun a period of concerted growth, as offerings by U.S. and European corporations and sovereign borrowers became more or less continuous, supplementing the funds raised and loaned in the Eurobanking markets.

Although the Eurobond market, whose market makers are located in a number of financial centers, including the U.S. and Japan, is not subject to national regulations, its investors, issuers and underwriters are frequently subject to regulation by their national authorities. Nevertheless, the trend in recent years has clearly been to open up national securities markets and thus to allow greater integration of these markets and other national and international markets. Recent examples include the removal by Germany and Japan of important restrictions on the use of their currencies in certain international financial transactions.

The securities issued in the Eurobond market have continued to be those of European governments, the most creditworthy of U.S. and foreign corporations, and international organizations such as the World Bank. One reason U.S. corporate borrowers have continued to be attracted to this market is that in recent years they have been able to borrow at cheaper rates than in the United States. In part, this is possible because securities are offered in bearer form, giving a guarantee of anonymity to the investor. Most of the investors in this market have been and continue to be foreign financial institutions and foreign residents.

Thus, the Eurobond market in its maturity is an effective alternative to national debt markets. As such, it provides an important means by which capital can flow between countries internationally, helping to promote its efficient allocation on a worldwide basis. During the 1980s, for example, the market has served as an important source of net capital inflow into the United States, a development which is a counterpart of the large trade deficit this country has been running over this period.

U.S. banks have been able to participate in the development and operations of international capital markets through foreign subsidiaries by reason of the broad statutory authority contained in the Edge Act (a section of the Federal Reserve Act). A principal purpose of that act, which was enacted in 1919, was to facilitate the international and foreign banking and financial operations of U.S. banks and to promote, thereby, the foreign trade and commerce of the United States. Through the creation of subsidiary corporations endowed with greater banking and financing powers than those possessed by domestic banks, it was intended by the U.S. Congress that U.S. banks should be able to compete more effectively with foreign banking institutions in U.S. trade financing and in international and foreign banking. The Federal Reserve Board has determined, through its regulations and orders in individual cases, which activities abroad are appropriate for U.S. banking organizations in the light of the purposes of the Edge Act and related statutes.

In the mid-1960s, as U.S. companies sought ways to raise medium- and long-term funds offshore to finance their direct investments and operations overseas, U.S. banks asked for authority to underwrite and deal in securities abroad through merchant banking subsidiaries. In this context, the Federal Reserve Board gave that permission to a number of subsidiaries, at first mainly in London but subsequently in other banking centers. Although the primary interest at that time was in underwriting and dealing in debt securities, authorizations were extended to equity securities and other securities containing equity elements. Subsequently, in the 1979 revision of its regulations regarding international banking, the Board placed underwriting, distributing, and dealing in debt and equity securities outside the United States on the list of permissible activities.

The Reserve Board's regulation admonishes the U.S. banking organizations that their underwriting and other activities abroad are to be carried out at all times with high standards of banking or financial prudence, having due regard for diversification of risks, suitable liquidity, and adequacy of capital. The Board monitors these activities through regular reporting requirements and the examination process.

U.S. commercial banks, as well as U.S. investment banks, have only become important underwriters in the Eurobond market in the 1980s. In significant part this prominence is attributable to the development of various innovative financial arrangements, most importantly currency and interest rate swaps. In its simple form, an interest rate swap, for example, involves two parties, one with a fixed interest payment debt, the other with a floating rate debt. These parties agree to swap their interest payment obligation. One or both parties enter these agreements to obtain a preferred interest payment stream and/or to lower borrowing costs. Because of the rapid growth of financial swaps and other innovative financial arrangements and the major involvement or international banks in their employment, the Federal Reserve is cooperating with other central banks in assembling information on these arrangements and to analyze their market implications and policy significance.

Future Prospects

Following this review of financial innovation and deregulation in the U.S., may I suggest a few lessons from our experience? Do not resist the deregulation of your institutions. The opening up of your financial markets to more domestic and foreign competition (including U.S. institutions) will be to the benefit of financial participants in Japan, the U.S., and the rest of world, as well as these economies in general. First, the consumer is better served by a market rate on his deposits and loans tailored to his changing needs. Business firms will be similarly benefited. Your management will benefit from the "on your toes" feeling which comes with heightened competition --your recruitment of bright young people will be greatly aided, and thus the long range future of the institution into which you have poured so many years will be enhanced. In the process of transition, some institutions will fall by the wayside, but without deregulation, firms outside your industry will find the legal loopholes and force a direction of change which may be contrary to the public interest, as they have in some cases in the United States.

Secure from your legislative bodies an adequate time frame in which you can transform your asset structure conterminously with freeing the liability side of your balance sheets. The U.S. transition was not balanced and the time to adjust was too brief. Test your strategic planning as to the best market niche or combination of services which will enhance your market share. No management can adequately achieve high performance in every field of activity the regulators may permit. Remember that the consumer may tend to single you out for those things you do best, and still go down the street for the other fellow's specialty. Note that the new services you render likely will serve better to expand your market share rather than become rich profit centers on their own. Your satisfaction and that of your customers will be derived from the superior service rendered by the best institution in the market.