DEREGULATION OF THE FINANCIAL SERVICES INDUSTRY: TOO MUCH OR NOT ENOUGH?
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During the three years on either side of 1980, deregulation was the talk of Washington. It even got quite a bit of action. Congress and regulators removed many constraints on prices, services, areas of operation and business practices in a variety of industries ranging from transportation to energy and financial services. Some of us believed that a long-needed movement to get back toward a free-market economy had begun and would continue as the benefits of the first wave of deregulation became apparent to everyone. But the deregulation wave has neither spread quickly to new industries nor continued with as much force as one might have expected. Indeed, calls for new regulation in several deregulated industries have all but drowned out voices of those who still see potential benefits from further deregulation.

Today, I propose to look into the slowing deregulation movement in the financial services industry, which happens to be the one I'm most familiar with but also is a uniquely important industry in any advanced economy. Indeed, the rising number of bank failures in recent years has caused some people to express concerns about the safety and soundness of our financial system and the possible repercussions on the entire economy if certain potential problems were to become real or existing ones worsen. My goal this afternoon will be to examine some of the arguments for reregulation as a basis for speculating about the future of deregulation and financial services generally.

The Regulatory System In Banking Before Deregulation

To place the current debate about financial deregulation versus reregulation in context, we need to ask what originally prompted regulation of many industries in what we call a free market economy. Looking back, one finds most regulations grew out of a situation economists refer to as market failure. In theory when the free market fails to meet a goal of society, the government should step in to adjust the market solution toward society's preferences. In practice, substantial problems often arise. Regulation may simply not be effective in achieving its goal, and it may have undesirable side-effects. Firms find ways around regulation, making it ineffective and costly. Regulation is certain to have compliance and enforcement costs, which may prove to be greater than its public benefits. Furthermore, regulation often promotes special interest groups which will make adjusting regulations to new market realities very difficult. Growing knowledge of these practical flaws in regulation came together with changing markets in the 1970s to spur the movement toward deregulation. In spite of significant competitive benefits that have followed, many people are concerned that the increased competition generates unacceptable risks and thus call for reregulation.

Like the airline and certain other industries, banking has followed this cycle from market failure and regulation to deregulation and finally calls for reregulation. One of the original rationales for the current bank regulatory structure and deposit insurance was to protect the financial system from another episode of horrors like those of the Great Depression. A major problem at the start of the Depression was the collapse of confidence, first in individual banks and later in the entire banking system. Intent on preventing future bank runs, Congress constructed a system that protected both bank depositors and banks themselves. Depositors were protected through federal deposit insurance. In order to provide banks further protection from runs, Congress and the Federal Reserve strengthened procedures for discount window borrowing for banks experiencing temporary liquidity problems.

A series of statutes and regulations was adopted by Congress, the states, and the bank regulators as a means of limiting the exposure of the FDIC to imprudent bank managers. Congress and the states limited new bank charters and new branches. They established extensive financial reporting requirements in order to keep tabs on the institutions they supervised. They engaged in on-site examinations which produced not only information but also more or less forceful guidance for the banks they examined. In this system a set of informal capital requirements evolved. These were designed to make sure that banks had a buffer of capital to allow them to sustain unpredicted losses. Furthermore, a series of restrictions was imposed on the activities permitted to commercial banks, bank safety being a major motivation though by no means the only reason. The temptation for bank managers to engage in high risk activities was further limited by a series of restrictions on competition. One already discussed--controls on new bank charters and branches--significantly constrained overall competition among banks. Deposit interest limits for banks set in the 1930s were designed to limit costs, and thus improve profitability and increase the probability of survival.

This regulatory framework imposed a variety of costs on different individuals and organizations--on depositors who could not get market rates for their money, on the institutions and their customers who paid the costs of reporting and dealing with examinations, and on the institutions which were assessed a premium for the insurance that protected their depositors from losses. Bank and thrift customers also paid the subtle cost of higher non-competitive prices which resulted from limited competition and entry restrictions in many geographic markets and perhaps in financial product markets. The protective system began to come apart when higher interest rates created an incentive to bypass many regulations and improved technology lowered the costs of skirting interest-rate, geographic, and activity barriers. Among the most successful at avoiding such restrictions were nonbank competitors. For example, the development of money market mutual funds, which used computer technology to offer a market interest, short maturity account to consumers, circumvented interest rate ceilings on deposits as well as the geographic restrictions on conventional banks.

The response of the Congress, the bank regulatory agencies, and the states has been a fair amount of ad hoc deregulation. Congress enacted the most important change in 1980, deposit interest rate deregulation. That was essential if banks and thrifts were to remain liquid, and the legislation gradually removed almost all the ceilings on deposit rates. Another significant move was to expand the powers to thrifts in both the Monetary Control Act in 1980 and the Garn St. Germain Act in 1982. The Comptroller relaxed restrictions on chartering new national banks, doing away with the test of economic need. For a time the Federal Home Loan Bank Board did the same for S&Ls. Regulators also provided for some deregulation by allowing banking organizations to form discount brokerages and investment advisory services.

Many of the states at first relaxed geographic restrictions on multioffice banking within their borders. Then as Congress failed to act on interstate restrictions, the states took the issue into their own hands with a variety of interstate banking laws--some allowing entry by banks from any other state, others allowing entry from a limited number of states on a reciprocal basis, some allowing limited service banks, and others allowing entry under special cases. All told, as of last fall, at least thirty-nine states had enacted laws allowing some sort of interstate banking. States also attempted to provide product deregulation by allowing state-chartered banks to engage in activities prohibited to national banks and nonbank subsidiaries of bank holding companies.

These actions provide a good start to the deregulation of the banking system, but many areas and activities "ripe" for deregulating were not. Congress almost completely deregulated deposit interest rates, but it continued the prohibition of interest payments on corporate demand deposits. This prohibition encourages unnecessary funds transfers by large corporations seeking a market rate and prevents many small businesses from earning any return on their excess balances. Opportunities for geographic diversification of loan portfolios and deposit base are still constrained by laws that limit branching and cross-state bank holding companies. Regional interstate pacts have made strides toward rectifying this situation and have shown that the worst consequences of interstate banking have been substantially overstated. Nevertheless, eleven states are still without interstate laws, and a hodgepodge of geographic limits continues to exist in the rest of the nation. In addition, most of the interstate laws now on the books prohibit de novo entry. This deprives consumers of a major benefit of interstate banking by eliminating the influence of potential new competitors waiting "in the wings" on prices and service quality in local markets.

The most important piece of unfinished work in the deregulation sphere is the relaxing of restrictions on banks' activities. Much of the deregulation of products and services has come through exploiting loopholes, and nonbank firms have been the most successful in doing this. Nonbank firms are now active in a variety of areas that were once the exclusive province of banks. Insurance companies such as Prudential operate nonbank banks, offer cash management accounts, manage money market mutual funds, and compete with banks for loan business. Investment bankers seem even more successful: they operate nonbank banks, offer cash management accounts, compete directly for loan business, and underwrite commercial paper.

Banks have gained some additional powers, but they have also lost some important battles. Even when Congress was in a deregulatory mode a few years ago, it took a step backward in the Garn-St. Germain Act by further limiting banks' ability to provide insurance to domestic customers. A lengthy battle has been waged in the courts over whether the underwriting of commercial paper is in violation of the Glass-Steagall Act. At present, banks may distribute this paper but may not actually underwrite corporate offerings. U.S. banking firms are currently permitted to engage in almost every investment banking function abroad. I find that the reasonable safety record so far is a little hard to reconcile with prohibitions on many of the same activities in this country. Since many large corporations are truly international, they may receive services from their banks that domestic firms are unable to purchase. Thus, the work of the deregulators is not finished in the banking area. Some product and geographic deregulation could actually enhance financial stability by permitting greater diversification. It would also increase competition and economic efficiency.

Reregulation

In spite of these economic advantages, the cries for new regulation have begun to drown out the plea for deregulation. Insurance agents and underwriters have fought to limit banks' powers to engage in general sales and underwriting at every turn. Investment banks have done the same in the area of securities powers. On the surface, these opponents' concerns have been primarily with conflicts of interest and fairness of treatment--things one should worry about. But self interest is also a factor.

This is not to say that there are no legitimate concerns. Since 1980 the number of bank failures has risen dramatically, leading some observers to blame this increase on the loss of protected markets and the phase-out of interest rate limits. Activity in financial markets and the number of financial instruments have risen even more dramatically than have bank failures. This is a breath of fresh air to some. However, it leaves others -- including many lawmakers and regulators--unsure of their grasp of the overall implications of market developments for financial system safety. More innovations provide, among other things, more opportunities to make mistakes and to fool customers and oneself. Some institutions found this out the hard way from events in the futures markets, the market for GNMA bonds, and the repurchase agreement market. Those of us who are charged with financial system safety felt plenty of fall-out from problems in these markets. One need only think back to the thrift situation in Ohio in the spring of 1985.

Some blame the interaction of deposit insurance and deregulation for the increase in the bank failure rate. Deposit insurance reduces depositors' incentive to monitor their bank's condition and, thus, relaxes constraints on bank risk taking. This problem, which is an example of what economists term moral hazard, occurs in many insurance relationships and in other situations. Until recently, the incentive to undertake additional risk was partially offset by regulations that limited bank risk taking. More importantly, limits on competition ensured adequate profits to all but the most incompetent bankers and made bank charters a very valuable possession. But innovation as well as limited deregulation have changed this.

Still, I do not blame deregulation for most of these recent problems. Burgeoning bank failures seem more closely related to disinflation. One only has to look at farm banks to see this connection, and earlier regulation has also been a source of weakness. By protecting banks, we weakened them and also made it difficult, if not impossible, for them to diversify. The linkage of much slower price increases and bank failures is most apparent among farm banks, which have seen crop prices and incomes of their customers decline while the value of farm land dipped as much as 50 percent in some areas. Other troubled banks also made bad bets that inflation would persist by making loans to customers in real estate, energy, or some other activities that depended on a continuation of high inflation. Even those who expect the most from financial deregulation find it difficult to credit or blame deregulation with disinflation or to blame it for farm problems, real estate overbuilding, or energy price declines.

I doubt that increasing regulation could return us to the more or less placid financial system of the early 1960s, even though I count myself among those who are uncomfortable with the rapid pace of change in the world's financial markets. Coming from a central banker, this statement may not surprise you. High and volatile nominal interest rates in the 1970s and early 1980s gave the movement a spark. Improvements in information processing and communications technology provided a medium, and innovators and their imitators made things happen in an industry which offered attractive profit opportunities. Much deregulation followed breakthroughs by innovators who found ways around regulatory barriers. Their private actions quickly found political support because they provided good prices and services, and consumers objected to regulating them.

Interest rates have come down and have been much less volatile, but we cannot expect financial service firms or the public to unlearn new techniques or to give up new technologies. Many of the changes in the financial markets are permanent. Yet the moral hazard problem created by deposit insurance remains and, as I'll note in a moment, may have grown more significant.

Policy Implications

Market discipline could obviously be improved by removing government protection of the banks and the banking system. However, I see no indication that safety has become a less important concern. The value of bank charters could also be restored through increased regulation, but as I previously argued, we cannot return to a system of protected markets to insure the profitability of institutions and the absence of disturbance from the financial system. Facing those facts, one has to look for other ways of achieving greater system safety. There are several alternatives; they are not mutually exclusive. Some are already being seriously explored by bank regulators.

At present the most popular way of reducing risk seems to be regulating financial decisions. With increased emphasis on capital requirements, we have devoted more and more attention to making banks provide a heftier cushion to protect their depositors and the FDIC. Capital/asset ratios at large banks have moved up quite handsomely in the interim, but some of us have the feeling that there is less than meets the eye in this. We seem again to have a case in which banks have found ways around binding regulations.

One way that banks have responded to the regulations is to substitute high risk, high return assets for ones that earn a lower rate of return but are safer and more liquid. Another response of banks has been to increase "off-balance sheet" transactions while slowing their rate of asset growth. Off-balance-sheet items allow banks to earn fee income for taking risks while avoiding the need to increase capital. Both of these responses by banks allow them to raise their measured capital ratios while maintaining their return on equity, but both may also increase the riskiness of the bank. After adjusting for changes in banks' balance sheets and off-balance-sheet items, it is hard to determine to what degree, if any, capital regulation has made banks less risky. The recently announced agreement by U.S. and British regulators is a step in the right direction.

Another way of encouraging greater safety would be to maintain government protection of some insured depositors at banking organizations but to impel uninsured depositors and holders of subordinated debt to exert more surveillance and discipline. The FDIC's proposals for limited payout of uninsured deposits at failed banks and for greater disclosure of banks' financial condition are examples of this approach. Another proposal is to require banking organizations to issue additional subordinated debt, which, like equity is uninsured but unlike equity pays a fixed return. Such creditors are less attracted by high risk ventures. A third way is to force banking organizations to place riskier activities into a separate subsidiary of the bank holding company. The theory behind this is that the nonbank subsidiaries could fail without affecting the bank subsidiaries that the government wishes to protect. An extreme version of the separate subsidiary approach would require the banking subsidiaries to act like money market mutual funds and invest in only short-term government securities (and perhaps also in high grade commercial paper).

All of these proposals for greater market discipline have been dealt a severe blow by events over the last few years. The handling of the failure of Continental Illinois demonstrated regulatory concern about the effect of large bank failures on the financial system. In this case the FDIC's handling of the failure protected not only the insured depositors but also the uninsured depositors and even the uninsured creditors of the bank holding company. More recently, one of the largest banking organizations in Oklahoma encountered severe problems, and the FDIC again stepped in with assistance in a way that protected the all of the holding-company creditors. The rationale behind the FDIC's action appears to have been that no other banking organization was interested in acquiring the troubled institution, and so this was the cheapest way of handling the situation. If we persist in bailing out all creditors, though—even those of the holding company, then none of the proposals for increased market discipline has much chance of success. I do not want to imply that the handling of these banks was a mistake. However, we cannot expect market participants to monitor bank risk closely if they expect that the government will absorb the losses in the case of a failure, and each new exception to the rule that uninsured creditors are at risk when large banking organizations fail creates expectations of future exceptions to the rule.

Conclusion

In conclusion, there is no clear answer to the question "Have we had too much deregulation or not enough?" In an economic sector that is essential to public welfare, particularly one in which risk taking is subsidized by compact, some elements of public control are necessary. Often regulation involves significant costs, and in many cases it will simply not work over time. Even though we believe that we are protecting institutions, we frequently end up making them weaker, which is the situation we face now. Then, when deregulation takes place, many firms are not in a position to survive competition and the onset of market discipline.

What specifically do we need to do? First of all, we need a road map to help previously regulated institutions make the transition to a less regulated environment. Encouraging them to build larger capital cushions is one way, and we have already started to do this. This also means finding appropriate ways of relating capital to risk instead of just concentrating on ratios. The approach taken in the recently announced American and British capital requirements is a move in this direction, albeit one that has imperfections.

Even if we strengthen financial institutions, I do not believe that we should remove all regulation. We are committed, in this country, to limited deposit insurance and to a lender-of-last-resort role for the central bank. This means that regulatory agencies must act to limit the risks that institutions under their purview take and to reduce the possibility of systemic failure. While some greater diversification of bank activities will reduce the aggregate risk that an institution faces, some activities may actually increase balance sheet risk. I do not think that we can protect a bank from the risks assumed by subsidiaries capitalized separately under their holding companies.

Innovation and creative accounting often break down these regulatory walls. Whether certain powers add or reduce risks is an empirical question, for the most part, and one that we should be studying.

We also need to enhance the role played by market discipline, even though it is often in conflict with short-term expediency. As financial institutions strengthen and as we get used to releasing more information about them, market discipline can assume more importance.

In summary, our task is to seek a balance that best achieves public goals. Rather than focusing on the theoretical arguments about what is the best equilibrium solution in the long run, though, we need to concern ourselves with how to achieve our goals given our current, and by no means optimal, situation. The future road of the financial services industry will necessarily involve elements of regulation and deregulation.