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REGULATING FLEXIBILITY: THE CHALLENGE OF BANKING IN THE OPEN MARKET
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To the Bankers Trust Conference on Managing Interest Rate Risk and Innovative Financing Structures
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Good afternoon! It's a pleasure to have an opportunity to discuss with so sophisticated an audience the challenge of regulating financial services without dampening the creative forces of the free market. Actually, the term "free market" as it is applied to the American business context is difficult to discuss without rather quickly coming upon a host of contradictions. Freedom in commerce has, since the anti-trust legislation of the nineteenth century, been interpreted as freedom to pursue the maximum return from one's investments and freedom from marketplace practices like monopoly and destruction of the environment. Our society's decision to place restraints on the freedom of the marketplace grows out of Americans' fundamental belief in fair play: if we're to play a game, we want the security of knowing that our chances of winning are not undermined at the start by some advantage held inequitably by the opponent. We want to know in general that the little guy is not going to be rolled over by the big guy just because of the size differential. Thus our objective might better be described as an open market that attempts to preserve freedom for its participants as long as they do not increase risk to society as a whole.

The challenge this open market poses for the financial system is containment of risk in the management of assets in a way that does not at the same time protect imprudent management from failure. The current state of semi-deregulation effectively extends the safety net beyond its intended purpose of insuring against public risk to underwriting private risk in ways that could ultimately threaten banking and other components of the industry. Meanwhile, banks still lack access to certain tools that

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could help them to profit. It would make sense, then, to provide banks with those tools as a balance for the restriction of riskier activities to which they have turned in an effort to remain competitive. I'd like to explore with you briefly, then, how we can achieve such a balance between the needs of consumers and bankers by touching on areas where both groups would be better served by further deregulation. I'll also suggest ways in which redrawing the distinctions between banking and commerce and enforcing tighter regulation of some activities would enhance the safety of the entire financial system. In this way, I hope to leave you with an outline of a financial services industry that can be flexible enough to keep up with changes in the market yet sound enough to resist being swept away by change.

Development of the Regulatory Framework: Origins

The banking industry was initially regulated to protect the little guy--the consumer whose economic viability had been traditionally entrusted to local banks. Prior to the opening of the Federal Reserve System in 1914 the consumer had been buffeted by money panics. Even after that, bank failures continued to imperil consumers before the institution of the Glass-Steagall guidelines and deposit insurance in 1933. These regulatory measures restored consumer confidence and ensconced banking safely in its own domain, allowing the industry to settle into nearly half a century of relative complacency. The ability to gather funds through non-interest-bearing demand deposits and low-yielding time deposits provided money that could be loaned to generate interest revenues, and this could be accomplished on one's own turf, as it were, since geographical limitations also cut down competition. Together the product and geographical definitions set by law helped establish the image of bankers as well-fed individuals who kept genteel business hours and spent long afternoons on the golf course.

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Breakdown in the System

Markets abhor complacency much as nature abhors a vacuum, however. Times change, and where complacency has bred stagnation, opportunities for profit under new conditions will be met by those with fresh ideas and more agility. So it was that in the 1970s two sets of unprecedented conditions shattered the complacency of the banking world and started the game anew. Those new elements were the high interest rates generated by severe inflation and the advent of refined electronic technology. The interest rate challenge was posed by new products and propelled in part by inflation and in part by the increased sophistication of consumers. In 1972 a Massachusetts thrift offered the first interest-bearing checking account, and in 1979 Merrill Lynch offered the cash management account as a way to simplify the management of personal funds. The CMAs combined money-market interest rates with check-writing privileges and opened the floodgates for a range of similar products. As depositors with traditional demand deposits deserted banks for the new accounts, disintermediation snowballed, forcing banks themselves to go out into the market and purchase funds to loan to some customers. Market interest rates severely narrowed the spread banks had enjoyed in their halcyon days and threatened their liquidity. In an effort to cut expenses, banks sought to eliminate the necessity of maintaining non-interest bearing reserves with the Fed by switching charters and jumping out of the system. While all this was going on, small savers were not being served as much as larger investors funds by the rush to the money market. The housing market was being hurt by the liquidity problems of banks and S&Ls. Glass-Steagall distinctions between bankers and brokers were blurring at the same time that the regulatory scope of the Fed was diminishing through attrition.

New applications for technology created difficult conditions that sprang to some degree from banks' early entry into the computer field. Banks' use of computers' capabilities helped to change the concept of money from a physical substance to a

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stream of information passing instantaneously at a distance via telephone wires. The shrinkage of distances in the transfer of funds helped to break down the geographical barriers that were built into early regulatory schemes. Not only could transactions across state line be done readily, but money markets began their relentless trek toward the 24-hour-a-day global format we now confront. Electronics also increased money turnover and altered the proportion of capital that banks were accustomed to holding. Banking was being pulled apart at the seams by forces it could not control due to its regulated status, and the financial system was teetering on the brink of the chaos that would have followed a general exodus from the regulatory framework.

Policy Respones: Ad Hoc Deregulation

To avert crisis--unfortunately the motivation that usually underlies such actions--two pieces of legislation were passed to allow banks to be more competitive. Congress enacted the most important change--deposit interest rate deregulation--in the Monetary Control Act of 1980. That was essential if banks and thrifts were to remain liquid, and the legislation gradually removed all the ceilings on deposit rates with the exception of demand deposits. Another significant move was to expand the same 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.

These moves addressed the first of the problems I outlined earlier--the interest-rate dilemma. Preliminary answers to the geographical question exacerbated by high-speed technology lay in the regulatory domain of the states. Many of the states at first relaxed geographic restrictions on multioffice banking within their borders. Then as

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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 forty-two states had enacted laws allowing some sort of interstate banking. Some 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.

Issues and Directions in the Present Environment: Further Deregulation

Thus although progress has been made, we are not yet on an entirely level playing field, to use the slogan of deregulation. In the first place, 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, eight 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.

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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' abilities 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. Thanks to the initiative of Bankers Trust, banks may now distribute this paper, but they still 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 promote financial stability by permitting greater diversification. It would also increase competition and economic efficiency.

Reregulation

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Meanwhile, in the inevitable free-market process of creating and filling niches innovation continues to outstrip regulation in the new products department, causing some people to call for re-regulation rather than deregulation. I don't like the term re-regulation because it seems to imply rolling back some of the progress we've achieved in the way of freer financial markets. I do, however, see a need for strengthened regulation in several areas.

The proliferation of off-balance sheet activities raises questions of potential insolvency that could, in some peoples' minds, eat away at the insuring agencies' ability to protect depositors. At the same time, the massive transfers of funds occasioned by the new range of banking activities places great burdens on the electronic wire system. We have today an uneasy mixture of payments systems subject to unacceptable credit exposure incurred in making and receiving payments in the round-the-clock, worldwide financial markets. We must also contend with the potentially disruptive condition that now allows a sizable fraction of large-dollar payments to remain provisional for periods of many hours. Having looked at those segments of banking that could benefit from further deregulation, I would suggest that off-balance-sheet activities and the large-dollar-payments mechanism present the most compelling cases for strengthened regulation. Off-balance-sheet activities allow far more risk-taking than is appropriate given existing capital levels. The use of free credit in large-dollar payments encourages economically unsound transactions and possibly increases risk. In both cases, market participants would tend to set prices that fail to take account of risks to third parties. For this reason, there is a need for regulation invoked with the intention of allowing financial institutions to adapt to the tempo of the market without violating the consumer's trust.

Toward that end, the fundamental historical principle of bank regulation in the

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United States--the separation of banking and commerce--should be clarified. One possible solution is a division of the financial services industry along lines similar to those proposed recently in a working paper by Gerald Corrigan, President of the New York Fed. This proposal would prohibit banks and thrifts from owning or being owned by commercial enterprises. At the same time, they would have access to deposit insurance and the discount window. They would also have access, along with their holding companies, to a unified and regulated electronic large-dollar payments system. Commercial companies offering financial services would be restricted to what are now classified as nonbank financial services.

In looking at the distinctions in the banking industry, we must deal with the unique problems of savings and loan institutions. The reality is that we now have numerous S&Ls that have failed in all but name, a situation that encourages managers to undertake high levels of risk in desperate efforts to save the day. Such actions increase the potential for loss to the beleaguered FSLIC, which will be called upon to reimburse depositors at an even greater cost due to the gambles of some managers. The threat to the FSLIC demands attention from Congress, and legislators have several possible courses they can pursue. The least productive among these possibilities would be to muddle along awaiting a crisis in the FSLIC that would lead to pressure for a bailout. In the current environment of concern about budget deficits, Congress would be hard-pressed to vote funding for rescue efforts from federal revenues, making lack of action on more viable alternatives even less acceptable. The Treasury's proposal that the FSLIC borrow money through home loan banks that would be paid back over time by member S&Ls merits consideration. Such a solution would entail higher premiums for thrifts, however, and institutions might respond by converting to commercial banks. If the number of conversions were large enough, the original purpose of the strategy could be defeated. Another possibility is the merger of the FSLIC and FDIC. Commercial banks

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are obviously uncomfortable with the merger option, but it has been suggested that the combined fund would be large enough to deal with the problem of foundering S&L's without necessarily forcing commercial banks to lose their annual rebates. While there is no easy solution in this case, I feel that the best alternative is to act quickly to make the two insuring agencies one.

It is possible that a combined fund would account for degrees of risk by imposing risk-based premia on certain institutions or surcharges calculated according to bank size. Since risk-based capital requirements are a substitute for risk-based insurance premiums, though, and in light of the fact that we are already progressing with an experiment in risk-based capital, I favor continuing to develop our expertise on the capital side of the balance sheet. Risk should be the basis of our capital requirements to back up off-balance-sheet items and other high-risk, high-return assets that banks have turned to for profit in response to regulation. New products like interest-rate swaps, caps, collars, and floors in addition to standby letters of credit, long the primary form of this kind of activity, have allowed banks to assume risks while avoiding the need to increase capital. In this way banks have been able to raise cash flow and measured capital ratios, but in the process they may also increase their riskiness. After adjusting for changes in banks' balance sheets and off-balance-sheet items, it is hard to determine to what degree, if any, current capital regulation has made banks less risky. The recently announced agreement by U.S. and British regulators is a step toward amending this situation, and I would hope that their efforts will be followed by further regulatory coordination.

Another way of encouraging greater safety would be to let the market do part of the work. We should maintain government protection of some insured depositors at banks. We should also, however, impel uninsured depositors and holders of subordinated

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debt to exert more surveillance and discipline on the institutions they patronize. The FDIC's proposals for limited payout of uninsured deposits at failed banks and for greater disclosure of banks' financial condition embody 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. Investors attracted to such instruments are less likely to be interested in high risk ventures. A third possibility is to force banking organizations to place riskier activities into a separate subsidiary of the bank holding company. The argument made by proponents of this approach is that nonbank subsidiaries could then be allowed to 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 only in short-term government securities and perhaps also in high grade commercial paper.

I don't find all of these proposals in favor of a greater role for market discipline in the banking industry equally compelling. In particular, reliance on subsidiaries to isolate risk seems to me somewhat unrealistic. However, an even greater hindrance to allowing the market to play a greater role is the message that regulators sent in conjunction with several events of the last few years, messages that have brought into question the extent to which the market will be allowed to run its course.

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

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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, in dealing with a mechanism like deposit insurance, we must be vigilant against the possibility of moral hazard. Insurance can become a self-fulfilling prophecy when its existence reduces caution and permits actions that would not be taken if there were no guarantees against loss. Thus 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. The rule must be that uninsured creditors are at risk when large banking organizations fail because every time an exception to that rule is permitted, expectations of future exceptions are encouraged.

Conclusion

Returning to the theme of the banking industry's place in a market that is as free as possible, the freedom to fail must not be removed from the equation. Neither the Fed nor the depository insurance agencies can be involved in propping up poor management, and as long as we remain committed to limited deposit insurance and to a lender-of-last-resort role for the central bank, 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 to institutions, some activities may actually increase balance sheet risk. As innovation and creative accounting break down these regulatory walls, those of us who act as regulators must continue to study the empirical facts of risk posed by banking activities. We should have the power to adjust capital requirements or insurance premia according to risk. In

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any event, we should not continue to protect a bank from the risks assumed by subsidiaries capitalized separately under their holding companies.

At the same time we can 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 forces can and should become more important in constraining institutional behavior.

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 combine elements of regulation and deregulation in a market situation that is, if not perfectly free, open to fair competition through service and innovation.

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