

**DEREGULATION OF THE FINANCIAL SERVICES INDUSTRY:  
TOO MUCH OR NOT ENOUGH?  
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Good afternoon! I'm pleased to have another opportunity to meet with you members of the I.A.F.P. Since successful financial planning depends on some sense of what lies ahead in the sphere of investment securities, I'd like to talk today about potential changes in the financial services industry that could have a sizable impact on you and your clients. The changes I refer to depend on the outcome of the debate between those who favor further financial deregulation and those who advocate new or renewed regulations.

Let me say at the outset that I, like many people, including not only economists but regulators and legislators as well, lean toward deregulation. It offers clear efficiencies and advantages to the consumer that are not likely to occur in an environment of strict regulation. The problem is how far to go in the way of deregulation and, perhaps even more difficult, how to get there. We are well aware that there are weak spots in our financial system even though it is basically sound. With this in mind, I believe we should proceed cautiously because we are moving into largely uncharted waters, with the almost daily advent of new financial instruments and the rapid global integration of capital markets.

To gain a better sense of where we ought to be heading, I think it is helpful to have some historical perspective into the current, somewhat confusing state of affairs. By looking at the big picture--that is, the logic of the regulatory framework that stood for almost half a century and the forces that brought us to our present condition of partial deregulation--I think we can see more clearly where we need to go and how we

should proceed. To that end, my remarks this afternoon will begin with a brief overview of the framework for regulating financial services, particularly banking, from its inception during the Great Depression to its dissolution beginning in the 1970s. Then I'll discuss the main issues that need to be addressed today, and I'll offer my opinion on that currently popular question, "Have we had too little or too much financial deregulation?"

### **Historical Overview**

Looking back, one finds most regulations grew out of a situation economists refer to as market failure. During the 1930s the large number of bank failures, widespread depositor losses, and the drastic decline of confidence in the nation's financial system led policymakers to establish a strict regulatory framework, which was based largely on the idea of segmentation. The approach to containing problems was to restrict rather closely what institutions could do and where they could do it. Congress, the states, and bank regulators adopted a series of statutes and regulations. Their purpose was to protect depositors while at the same time limiting the exposure of the federal deposit insurance fund--the FDIC--to potential imprudent actions by some 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, and limits were imposed on deposits.

This regulatory framework worked reasonably well for many years, but it did have flaws. It 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.

Despite these flaws, the System remained viable until the 1970s. It 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. By changing the concept of money from a physical substance to a stream of information passing instantaneously at a distance via telephone wires, computer technology had already paved the way for making the geographic elements of our regulatory system obsolete. The ability to transfer funds electronically helped to break down the geographical barriers that still restricted competition. Not only could transactions across state lines be done readily, but money markets began their relentless trek toward the 24-hour-a-day global format we now have. 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. Thus, during periods when market rates were above interest-rate ceilings, regulated financial intermediaries faced large deposit outflows.

The fact that such problems arose is not surprising or especially unique to the financial sector and indicates the problems associated with regulation. Over time, innovators find ways around regulation, making it ineffective and costly. There are also

compliance and enforcement costs, which may prove to be greater than its public benefits. Furthermore, regulation often weakens the institutions that it sought to protect, making it difficult for them to adjust to new market realities. Growing knowledge of these practical flaws in regulation came together with changing markets in the 1970s to spur the movement toward deregulation.

### **Policy Response - Ad Hoc Deregulation**

The response of the Congress, the bank regulatory agencies, and the states to the growing problems associated with regulation was deregulation, but in an ad hoc way. The Monetary Control Act of 1980 gradually removed interest-rate ceilings on most types of deposits. The powers of thrifts were expanded 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 states also relaxed their banking restrictions. At first a number loosened constraints 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, at least 45 states have enacted laws allowing some sort of interstate banking. States also attempted to provide some product deregulation by allowing the banks they charter to engage in activities prohibited to national banks and nonbank subsidiaries of bank holding companies.

This ad hoc approach to resolving the regulatory problems of the late 70s and early 80s left us with a partially deregulated financial services industry. That's not a good situation for several reasons. First, some of the obvious areas that were not deregulated leave institutions handicapped in their efforts to compete. We are not yet on an entirely level playing field, to use the slogan of deregulation. Second, the continued prohibition of interest payments on corporate demand deposits encourages unnecessary funds transfers by large corporations seeking a market rate and prevents many small businesses from earning any return on their excess balances. It also adds to systemic risk by increasing the turnover of funds flowing through the payments system.

In addition, loan portfolios at smaller banks and deposit bases could be better diversified geographically if they were not constrained by laws that limit branching and cross-state 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, five states are still without any sort of interstate laws. The hodgepodge of geographic limits elsewhere is certainly not a very efficient regulatory framework. 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 potential new competitors waiting "in the wings" would have on prices and service quality in local markets.

The most important unfinished piece of 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. Although their proliferation was halted by the recent banking act, existing 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 these corporate offerings. U.S. banking firms are currently permitted to engage in almost every investment banking function abroad, albeit to a limited extent. I find it a little hard to reconcile this 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. In fact, some product and geographic deregulation could actually enhance financial stability by permitting greater diversification. It would also increase competition and economic efficiency. Enacting legislation that would permit interest payments on corporate demand deposits, move the United States toward full, nationwide interstate banking, and expand bank powers to include at least some insurance and investment banking activities would serve to complete much of the thrust of deregulation begun a decade ago.

### **Exceptions to Deregulatory Approach**

Unfortunately, other problems loom on the horizon that suggest we cannot simply

apply the nostrum of deregulation to all financial issues. I do not believe, for instance, that we can allow complete product deregulation for banks. A bank cannot be sufficiently protected from the risks assumed by subsidiaries capitalized separately under bank holding companies. Innovation and creative accounting often break down these regulatory walls. Whether certain completely new powers would add or reduce risk is an empirical question, for the most part, and one that we should be studying.

What's more, I also see a need for strengthened regulation in several areas. One important issue calling for more comprehensive oversight is off-balance sheet items. New products like interest-rate swaps, caps, collars, and floors--in addition to standby letters of credit--have allowed banks to potentially assume risk while avoiding the need to increase capital. Too rapid proliferation of these activities could lead to insolvency, not only of the institutions immediately involved but of their insuring agencies and their depositors. Several of the off-balance-sheet activities allow far more risk-taking than is appropriate given existing capital levels but banks find them attractive since they have been able to raise cash flow and measured capital ratios.

The obvious solution is to have requirements that capital be adequate to back up off-balance-sheet items and other high-risk, high-return assets to which banks have turned. Moreover, these requirements need to be coordinated internationally, or else the problem will just move offshore, out of the "grasp" of U.S. regulators. The recently announced agreement by U.S. and British regulators is a step toward amending this situation, and I would hope to see more countries coordinate regulatory policies along these lines.

A second potential problem needing strengthened regulation involves the payments system, particularly the electronic payments system. The fact that a sizable fraction of

large-dollar payments remain provisional for periods of many hours poses the danger of enormous disruption. The use of free credit in large-dollar payments encourages economically unsound transactions and probably increases risk. The present arrangement leads to prices that fail to take account of risks to third parties.

A third issue that some see requiring tighter regulation is deposit insurance. Insurance reduces depositors' incentive to monitor their bank's condition and, thus, relaxes constraints on bank risk taking. 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. Innovation as well as limited deregulation have changed this, though.

This problem, which is known in the insurance industry and by economists as moral hazard, is not hypothetical but quite real, as revealed by the FSLIC's ills. The straits in which this fund finds itself aptly demonstrate what happens when managers take excessive risks with depositors' funds. Congressional action was a necessary step because of the immediacy of the problems. It's only that though--a first step. Now that we have patched up the deposit insurance problem at hand by recapitalizing the FSLIC, we must address the broader issue of moral hazard in all deposit insurance, as it is currently configured. Some people are advocating that deposit insurance premia reflect the degree of risk undertaken by various institution's size. This is possibly one approach that we could take. Risk-based capital requirements may be a substitute for risk-based insurance premiums. Since we are already progressing with an experiment in risk-based capital, it might be best to continue developing our expertise on the capital side of the balance sheet. Whatever approach proves more effective, it is imperative that the issue remain in the forefront of our attention.

### **New Regulatory Framework Called For**

Each of these problems--off balance sheet activities, deposit insurance, and large-dollar overdrafts on the electronic payments system--deserves the attention of policymakers as do issues like commercial demand deposits, interstate banking, and bank powers, where further deregulation seems to be indicated. However, rather than deal with these as well as others that may arise in the future on an item-by-item basis, I think it's time we took a more comprehensive look at the financial services industry and shaped policy from a broader perspective. If we don't at some point take time out and go through this exercise, I think we'll be forever putting out fires. The reason is that ad hoc regulation simply encourages institutions to find ways around it--by offering new products, by operating under a new charter, or, in today's global financial markets, by going offshore.

In redesigning our approach to regulation and deregulation, we also need to avoid one of the flaws of earlier regulation, which was that by protecting banks, we weakened them and also made it difficult, if not impossible, for them to diversify. When conditions change, innovation by competing institutions breaks down the barriers that regulators set up, and hitherto protected institutions are unable to respond effectively. One way of avoiding this pitfall is to fashion, whenever possible, regulation that allows a greater role for market discipline. That may sound like an oxymoron, but I think such rules can be devised. In the case of deposit insurance, for instance, by limiting payment of uninsured deposits at failed banks we could impel uninsured depositors to exert more surveillance and discipline on the institutions they patronize. We could also require banks to increase the amount of subordinated debt they hold since holders of such debt, which has a fixed return, are less attracted to high-risk ventures than equity holders.

In addition, we must stick by our guns once we say we are going to let markets do their work. When Continental Illinois was on the brink of collapse, the FDIC protected not only the insured depositors but also the uninsured depositors and even the uninsured creditors of the bank holding company. Whatever the rationale in this and other cases, and they probably were quite compelling at the time, if we persist in bailing out all creditors--even those of the holding company, then none of the proposals for increased market discipline has much chance of success. This standard will be much easier to adhere to, of course, if we start now to deal with the problems and issues I've outlined rather than wait until a crisis is at hand. Keeping an eye on the long-term goal, even while we try to fix present problems, should also keep us from locking ourselves in to the past as we do inadvertently when we protect and bolster weak institutions.

### **Conclusion**

In conclusion, there is no clear answer to the question I posed earlier: "Have we had too much deregulation or not enough?" In an economic sector that is essential to public welfare, some elements of public control are necessary. 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. On the other hand, regulation often involves significant costs, and in many cases regulatory systems become outdated and inoperable. If we stick with such a framework or try to shore it up, in an attempt to preserve the weakest links, we frequently end up making institutions weaker, the situation we face now. Then, when market forces erupt as they eventually do, many firms are not in a position to survive competition and the onset of market discipline. Our challenge is to seek the optimal balance between regulation and deregulation. In my view, we can best do so by devising rules that let markets play a larger role in enforcement.