

**DEREGULATION OF THE FINANCIAL SERVICES INDUSTRY**  
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**to the Economic Club of Connecticut**  
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Good afternoon! I'm pleased and honored to be part of your annual economic outlook seminar. Your other speakers this afternoon will discuss the economy in general and present outlooks for specific industries. I too intend to address the outlook for a specific industry--financial services--but I am not going to talk so much about what I feel might happen over the next year. After all, this industry ebbs and flows pretty much in concert with the economy. Instead, I think it is more important to consider where this vital part of our economy is, or ought to be, heading over the longer term. This matter is especially relevant today because the financial services industry stands at a crossroads in some respects. On one hand, there is a growing awareness that the problems in the regulatory framework that has governed this industry for half a century is beyond "patching." On the other, we cannot dispense totally with regulation in this critical industry any more than we can in airlines or health care. In this latter respect, we have moved beyond where we were at the start of this decade when deregulation seemed to be the simple answer to so many problems.

That the coming year is expected to be a watershed for the financial services industry is apparent in the sudden appearance of a range of major proposals for regulatory reforms and industry restructuring. Therefore, I will focus my remarks today on this issue of deregulation, or perhaps more aptly, regulatory change. To do so, I shall begin by reviewing the industry's current problems. Then I'll briefly recount how the financial services industry came to have its present structure and discuss why problems arose with this framework. Finally, I'll zero in on measures I think will prove most effective in bringing us to where we want to be, namely, to a state where we have a truly

competitive—and that means in global terms as well—financial services industry, one which offers customers the fullest array of services at the best price but also one that is sufficiently safe and sound that, should problems arise, they would not spill over and disrupt the economy as a whole.

### **Current Problems**

The symptoms of the financial services industry's troubled state are visible in declining profitability. The latter problem is most severe for the smallest banks and suggests that we will see more failures as time goes on. These symptoms certainly point to some root cause, but observers are divided on the question of what that cause might be. Some see the culprit as inadequate deregulation, and there is certainly some truth to their arguments in regard to geographic restrictions. States have taken the first steps toward full, nationwide interstate banking, but these regional pacts still leave us with a hodgepodge of laws that is both confusing and less than optimal in terms of competitive benefits.

Others, especially banks, see the problem as a playing field that's still not level. Technological innovations and economic forces like inflation began to open up cracks in the financial industry's structure in the 1970s. Banks, which had enjoyed a virtual monopoly in their primary businesses, quickly found themselves unable to compete with other financial companies that were less constrained by state boundary lines and in the types of products they could offer. The Monetary Control Act of 1980, or MCA 80, and the Banking Act of 1982, which extended more competitive possibilities to thrifts, temporarily stemmed the tide of discontent. However, frustration has continued to gather momentum as banks are still unable to offer a full range of services and view this state of affairs as especially constraining in the face of growing competition from nonbanking companies.

I agree that deregulation should be extended, both geographically and, ultimately, in terms of product lines. At the same time, I think current reality is too complex for us to proceed by simply granting banks new powers and generally "deregulating." There are three primary reasons why we must proceed with caution. First, not all institutions are healthy enough to withstand the stresses that deregulation would bring to bear upon them. Second, the public does not have sufficient information at its disposal to allow it to make intelligent choices among the more or less risky options that deregulation could present them with. Third, and most importantly, we have allowed the safety net provided by deposit insurance to become so extensive that it protects parts of the business that were not intended to be insured in the first place. By insuring depositors, something to which we as a nation have become deeply committed, we have inadvertently created incentives to bank managers to undertake excessive risks, especially when their institutions are already facing problems. Moreover, because the implicit safety net has been broadened by bailouts of major failed institutions, it mutes not only depositors' but also stockholders' and other creditors' incentives to monitor the activities of their financial institutions. This is the problem economists call moral hazard, but it is no mere economic abstraction. The cost of failures to the FSLIC ought to teach us this lesson. If we were to grant banks wholesale new powers in the present context, there could well be an enormous drain in the now healthy FDIC fund because new powers also entail higher risks.

These difficulties have also been recognized by regulators and other financial industry analysts, and their thoughts on how to address the situation have coalesced into several interesting proposals for restructuring the financial services. Of course, in a presentation of this nature I would not attempt to critique as broad a range of ideas as these proposals represent. In general, however, suggestions like those offered by New

York Fed President Gerald Corrigan, by the FDIC, and by "safe bank" proponents perpetuate a separation of banking and commerce through the maintenance of so-called "Chinese walls" either between types of institutions or between the various divisions within an institution. My own view of the matter is that the institutional approach is a vestige of market conditions that no longer exist. I think we need to adopt a more functional stratification among products that institutions offer and free our thinking from the notion that walls between structural units can solve the industry's problems. Before I go over my ideas, a brief review of the history of today's regulatory system that separates banking from commerce and the legacy of that system in our own day will offer some context to my thoughts on why and how we should make changes.

#### **Rationale for Separation of Banking and Commerce**

The rationale for separation of banking and commerce arose most directly from concern over the safety and soundness of the banking system in the throes of the Great Depression. In the 70 years prior to 1933, banks carried on investment banking activities in addition to deposit-taking and the extension of long- and short-term credit. The Banking Act of 1864 had initiated a period of "free banking," as it was called, by allowing banks whatever powers were deemed necessary to the business of banking. The purchase and resale of new stock and bond issues grew naturally out of banks' experience in long-term credit and underwriting of state and federal debt instruments.

Although there were the inevitable cases of fraud that occur in every industry, in general the mixture of banking and commerce during that period is seldom blamed for any disruptions in the banking system. Panics like the one in 1907 tended to result from lack of liquidity. In fact, one of the basic reasons for establishing the Federal Reserve System in 1913 was to help the economy through such times. Even the the collapse of the commercial banking industry between 1929 and 1933 seems not to have been related

to problems with either banks' investment banking or direct investments in securities. Rather, it arose from a crisis in consumer confidence stemming at first from failures in small, poorly capitalized agricultural banks unable to deal with declining commodity prices. Nevertheless, the stock market crash of 1929 and revelations of abuses by the securities affiliates of large banks, combined with the suspension of operations by some 20 percent of America's commercial banks, helped create an atmosphere in which segregating the two types of businesses seemed proper, indeed necessary, to legislators.

The Banking Acts of 1933 and 1935 settled the matter with two sweeping gestures—deposit insurance and industry segmentation along institutional, geographic, and product lines. Deposit insurance was intended to enhance the safety and soundness of the banking system by eliminating the danger of bank runs: depositors no longer needed to worry since their funds were guaranteed, now up to \$100,000. These laws also aimed at making the financial sector safe by prohibiting banks from underwriting corporate equity issues or purchasing equity securities for their own portfolios. In return, however, banks were given cartel-like powers over other products like demand deposits along with geographic limitations that also curtailed competition. Banks were thus treated as "special" corporate institutions. The perception of specialness is something that has marked banking since Parliament placed restrictions on the Bank of England in response to merchants' fears that banks, with their massive concentration of funds, posed an unfair competitive threat. In more recent times, as banking became increasingly involved with the business of the general public, the fear that waves of failures could be caused by a broad-based loss of confidence in banks was added to the reasons for treating banks as special. Patterns of failures like those in 1907 and the Great Depression endangered the entire monetary system along with the savings of individuals.

These two measures—deposit insurance and segmentation of banks from thrifts and

other financial intermediaries—seemed to succeed in making the nation's financial system safe and sound, but their effectiveness was largely a function of the economic stability of the next three decades. When this environment began to change in the 1960s and especially in the 1970s, as inflation and interest rates rose sharply, the structure proved counterproductive. At that time, higher interest rates created an incentive to bypass many regulations, while 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. Segmentation actually tended to make banks structurally and psychologically uncompetitive and left them unable to respond to these challenges.

Because federal legislators chose the course of insurance and segmentation as the framework for dealing with financial industry problems, only they can help banks strengthen their atrophied competitive prowess. Lawmakers in Washington began this process with MCA 80 and the Banking Act of 1982, which together made the playing field increasingly shared by banks, thrifts, and nonbanks somewhat more level. All could compete in offering interest-bearing checking accounts and long-term CDs, for example. Still, the playing field today is not level enough to prevent bank profitability from falling or to provide customers with the better service and prices that further deregulation could bring.

### **A New Approach**

Where should we go from here? Is it enough to graft new powers and additional Chinese walls onto the existing framework? I think not, for the reason that we still must

grapple with the question of how far deposit insurance extends. As I mentioned a few moments ago, we have let the safety net spread too far, essentially underwriting much riskier activities as time goes on. What I propose instead is that we focus our strategy on narrowing the safety net as a necessary prelude to granting banks new powers over time. Let me elaborate briefly on how we could do so. The vehicle I suggest for limiting insurance is a transactions accounts, insured initially up to \$100,000 and backed by government securities. Any holding company would be allowed to offer such an account through a single-purpose entity I call a "fail-safe" depository. These entities would be distinct from all other affiliates including what we now know as banks and thrifts. The latter could also offer transactions accounts. However, like insurance, securities, and other activities that ultimately could be offered through affiliates of such holding companies, bank and thrift deposits would not be insured. Of course, we would have to do a good job of educating the public that we are narrowing the safety net.

My proposal is, I believe, more viable than the alternatives now being advanced. It narrows the safety net, thereby reducing the moral hazard problem, and in the process sets the stage for further bank deregulation. This approach is more realistic than simply reverting to the law of of caveat emptor by doing away with the safety net and all banking regulations. In today's complex market more than ever we cannot expect the average consumer to have the professional investors' savvy of the money market or to use that knowledge to exert discipline on banking institutions that engage in a very broad range of activities. We must honor this nation's commitment to provide a minimal safety net for individual deposits while at the same time making sure that it does not hamper the effectiveness of market discipline on banks.

My approach is also, I feel, more practical than the several proposals for banking reform that I referred to at the outset because it moves the focus away from the notion

that we can control risk in the financial services industry by specifying a structure for that industry and enforcing a corresponding regulatory segmentation that will last. This Depression-era approach of segmentation is shared by most of the major reform proposals in that they are all premised to a greater or lesser degree on the belief that banks are "special" kinds of institutions. The argument of specialness makes some sense in light of the fact that banks issue the bulk of the public's liquid assets and have an intimate link with the payments system. It seems intellectually tractable in view of the long-held notion that there is a clear distinction between the production of tangible goods and financial or "paper" products. Over time, however, it has grown increasingly difficult to separate banks and financial intermediaries from other firms in the business of processing information.

In the past banks took deposits and loaned them out again in a rather narrow sense. Now the money center model of charging fees and processing for packaging loans represents the direction in which the industry is heading. There is little to distinguish banks from other segments of the financial services industry in this regard. Thus there would seem to be no logical reason for treating intermediary institutions differently from other commercial enterprises engaging in similar activities. Nevertheless, the proposals for restructuring the financial services industry that have been made to date would continue for the most part to treat banks in a special manner. They would redefine and add separate affiliates. Indeed, by aiming at reforming institutional structures, they tend to solidify special treatment as a policy imperative. As time goes on, however, the walls we create--be they "fire" or "Chinese"--have a tendency to develop holes and crumble. This occurs partly because of the predictable economic incentives to avoid any binding regulation but also because the differences between the services provided by these entities inevitably blurs.

Even if banks are not special, however, money is, in the sense that it serves as the safest, most liquid asset. It is a sort of anchor at one end of the range of financial assets, and I believe that there is a legitimate demand from the public that the anchor be secured by the government. We can and we should meet that demand with a safe asset that will act as a transactions medium and a link to the payments mechanism. In the past, a sound currency met this need, but in today's world "money" as I am referring to it here must also include other transactions mediums, particularly checks. However, in the course of offering a depository vehicle that is fail-safe, we are not obliged to insure all accounts in designated financial institutions up to a prescribed amount. That is why I propose limiting insurance to a single transactions account. As I said earlier, the entities that provide such an account could be separate affiliates of any company over time, but they should be strictly restrained. In current parlance, the providers could be subsidiaries of holding companies.

We would probably be able to eliminate the necessity for insurance per se, of course, if we mandated that these secured deposits had to be invested exclusively in short-term Treasury securities. Since fraud is always an unfortunate possibility, though, some insurance or government guarantee would probably be needed. There would clearly be a need to examine them to make sure that their investments were in government securities and that no transactions with other affiliates occurred. The distinctions between other affiliates might blur, in the sense that many banking activities are indistinct from investment banking ones. For example, interest rate swaps might be booked in the bank or the securities affiliate. But the distinction between what is the safe depository and any other part of the holding company would be strictly preserved. It's very simplicity makes this feasible.

I should emphasize that this proposal is a trial balloon at this point. Clearly, we

will not wake up tomorrow with yet another fully developed financial entity in place and with all the other problems we have at present solved. There is no clear-cut empirical evidence as to how large the public's demand for an insured deposit really is. What I suggest, though, is that we start by enabling institutions to have these entities with transactions deposits of up to \$100,000 and, simultaneously, we begin educating the public to the fact that the safety net is now shrinking. We will also need to make provisions for giving the public additional information regarding the institutions on which they have uninsured claims.

The availability of information is a crucial factor in the potential effectiveness of my proposal. Once we narrow the safety net by providing that only the anchor asset would be insured, we could begin granting expanded powers to banks, but only if the public has been adequately educated as to the implications of the new arrangement. Since we now have quite a broad psychological safety net, it would take a concerted effort on the parts of banks and regulators to ensure that as many depositors as possible were aware that by putting their funds in the designated anchor asset they would be covered by federal insurance. By the same token, however, depositors would have to be informed that whenever they invested in other products in the very same company, they were exposing themselves to some degree of risk. Regulators would have to continue supervising financial intermediaries until we were convinced that public consciousness had been raised sufficiently. Then regulation could diminish gradually until only the insured instrument came under the purview of examiners. We would be left at that point with holding companies which were chartered to offer insured accounts in an affiliate as part of their range of services. They could offer commercial and financial services in others. While particular activities would probably continue to be regulated, the organizational form would not be, with the exception of the insured depository.

What I am suggesting, then, is really pretty simple. First, we should move to narrow the safety net provided by deposit insurance so that over time we stop inadvertently fostering risk in the very institutions we are insuring. Second, we need to free ourselves of the idea that we can solve current problems with new institutional structures that will last. The ideas presented to you today establish a broad conceptual framework as opposed to particular details, but they are intended to move us in a new direction. Regulators should be empowered to shift their sights from all the activities of a holding company with an insured subsidiary to one very clearly defined activity. I think that after setting aside one form of asset to satisfy consumers' need for safety and engaging in an extensive program of education to make consumers aware of the risks inherent in exercising their depository options, we would be in a position to give bankers the latitude they ask to compete more effectively. By narrowing the scope of public policy concern to one insured account, it would no longer be necessary to maintain sharp distinctions within the financial services industry or walls between functional divisions of holding companies. The elimination of such boundaries is essential, in my opinion, because I am not persuaded either by past experience or by present arguments that such boundaries can be guaranteed to remain impermeable. Despite the urgings of some theorists that a quick solution is possible, though, we would not be able to move precipitously. Time would be needed to allow weakened institutions to gather strength and also to test the effects of an account like the one I've suggested on the money supply. In the latter regard, questions of public acceptance and the availability of investment instruments would need to be addressed. We simply don't know right now what the demand would be for this type of risk-free transactions account.

### **Conclusion**

This proposal may seem dramatic, and there is no doubt that attempting to put it into practice would present numerous challenges. Nevertheless, I believe that by acting

in a deliberate manner, we can work from our base in the present structure toward a financial services industry that is less subject to the "moral hazard" problems of an overly extensive safety net and more responsive to the marketplace. If this can be done at the same time we acquit our obligation to maintain the safety and soundness of the system, we will have finally accomplished the task of effective deregulation.