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Designing effective regulation

As you know, our mission at the Fed is to foster the stability, integrity, and efficiency of the nation's financial and payment systems. We do that to promote maximum sustainable growth.
The Federal Reserve, and the Chicago Fed in particular, are very interested in better understanding how financial intermediaries work and interact with one another. The Federal Reserve Bank of Chicago has a unique relationship with the industry because of its close proximity to the futures and options exchanges here. We have promoted debate on important public policy questions relating to financial markets, derivatives, and the payments system. We've done this through research conferences with the Chicago Board of Trade, the Mercantile Exchange, the World Bank, and our annual Bank Structure Conference. The theme of next year's Bank Structure Conference will be "Payment Systems in the Global Economy." We also have a small group of individuals on our staff doing applied research on these and related subjects. The importance of the relationship between the financial markets and the payments mechanism became clear in 1987 with the need to accommodate the payment requirements of the industry.

As you know, the Fed does not supervise the clearinghouses or the exchanges. But we do have responsibility for the safety and soundness of the major settlement banks and bank futures commission merchants. We also have responsibility for the overall health of the payments mechanism. For these reasons, we're very interested in the interactions among the financial markets and the payments system. They're very important to us.

On this subject, one change that the Fed will implement next month is extending Fedwire operating hours. Beginning Monday, December 8, Fedwire will open at 12:30 a.m. eastern time — eight hours earlier than its current opening. This change was initiated in part to accommodate the needs of global financial markets. We hope that the new hours will improve settlement efficiency and reduce the risk for the industry's clearinghouses and settlement banks.

Today, I'd like to discuss two topics that are vital to the industry and to us at the Federal Reserve:

- the nature of the changing financial markets; and
- the design of effective regulation.

The events of the last several weeks have brought home to the general public the worldwide nature of today's financial markets. The global aspect clearly isn't news to anyone in this room.

Our financial system — one characterized by innovation and rapid change — provides many significant benefits to our economy. But one of the consequences of this dynamic system is that it's subject to periods of stress. There are a number of well-publicized examples — the 1987 stock market crash and the Mexican Peso Crisis, to name a few.

These periods of economic stress reinforce two key themes. First they remind us of the importance of maintaining effective monetary policy, sound fiscal policy, and efficient financial systems — a point that was emphasized in a conference we co-sponsored with the World Bank last June. Second, they remind us that for regulation to be effective, it should not be made in response to times of stress. Rather, regulations should be designed with an eye for the long term and be guided by certain clear objectives.

With this as background, let me now turn to the changing nature of financial markets. Change is the operative word for our industry and has been for a quite some time. However, I think it's important to note that even as the structure, products, and delivery of services has changed, the role of financial markets has not changed. Their core functions remain the measurement, acceptance, and management of risk.

In this context, I'd like to mention just a few of the fundamental forces shaping our financial system.

Perhaps the most profound development in the financial markets, and one that Chairman Greenspan and others have spoken on in the past, has been the rapid growth of computer and telecommunications technology. Technological change has lowered the cost and broadened the scope of financial services. It has allowed for the unbundling of many financial transactions. Consider for instance the mortgage product from ten years ago and the mortgage products today where origination, servicing, insurance, credit risk, and interest rate risk can be handled by different entities, and many times are.

But technology has been a two-edged sword for financial institutions. On the one hand, the rapid growth of new products, from derivatives to securitized loans, would not have been possible without the computer and telecommunications revolution. On the other hand, technology has played a critical role in the creation of substitutes for many traditional bank products, from retail deposits to short-term credit for high-quality borrowers.

The boundaries of technological change are being pushed ever outward. This trend will surely continue. We can expect the market to respond in innovative ways to the changing demands for financial services— many of which would have been impossible only a few years ago.

A second important force shaping the financial system has been the rapid pace of financial globalization. We've all seen the dramatic growth in operations of branches and subsidiaries of financial institutions outside national borders. But the degree of international integration goes far beyond foreign offices. It encompasses a sharp increase in asset holdings across borders, greatly increased trading in real and financial assets, and greater international flows in bank and nonbank credits. Lower-cost technology has supported this rapid growth in international banking. It's improved the ability of customers to borrow, deposit, or take advantage of risk management opportunities offered anywhere in the world.

Trade in goods and services as a percentage of GDP has also been increasing for quite some time — a trend that began long before NAFTA and GATT. These two trade agreements are part of a trend I expect to continue well into the future.

The third development reshaping financial markets — deregulation — could be seen as an independent factor or as a reaction to technological change and globalization.

As the market continues to evolve, it will be more difficult to maintain the rules and regulations established for a different economic environment. Public policy goals, namely, economic growth and macrostability, will remain the same. But market forces will continue to displace outdated restrictions, as we have seen with respect to interstate branching.

The three forces I've discussed — the technological revolution, globalization, and deregulation — have transformed the way financial institutions carry out their functions. This is perhaps most clearly seen in your own sphere — the financial derivatives market. Some types of derivative instruments have existed for hundreds of years. But the scale, diversity, and complexity of financial derivatives activities have greatly increased in just the last fifteen years.

You understand the important economic function of derivative contracts. Banks, other financial institutions, nonfinancial businesses, and governments are all aware of the need to manage financial risk, and all have discovered that, if they don't manage it, these risks could affect their ability to perform their economic function.

Derivatives are the vehicles that allow lenders and borrowers to adjust their risk profile at low cost. As I said, the present scale and complexity of these instruments could not exist without the use of computers and the rapid expansion of telecommunications. They could not be priced properly. The markets they involve could not be arbitraged properly. And the risks they give rise to could not be managed properly without high-powered data processing and communications capabilities.

Technological change, globalization, and deregulation have affected more than just derivatives. They have worked together to blur the traditional differences among financial firms. Direct borrowing in capital markets has become a close substitute for bank credit. Information has become available to more investors at low cost. Institutions are competing directly in more and more markets. It's clear that institutions that are subject to outdated regulatory restrictions will find these limitations more and more problematic in the future.

Glass-Steagall is a good example. Repealing this Act prohibiting mergers between financially related firms would not be a major innovation in and of itself. Rather, such deregulation would be a recognition of market reality, much as we've seen with the removal of restrictions on interstate branching.

This brings me to my main point today, identifying core principles for effective regulation.

As financial market participants, you're keenly aware of some of the limitations of regulation. For instance, effective regulation relies on information and disclosure, yet this information is costly and not always readily available. Regulations may also bring about unintended behavior. Sometimes regulations meant to address market failure are the root cause of problems in the financial markets. Deposit insurance with its role in the S&L crises of the 1980s is a good example.

Given the rapid pace of change in financial markets, we are clearly beyond the point where it makes sense to approach regulation on a case-by-case basis. Therefore, let me propose three fundamental principles for regulators and legislators to keep in mind when designing regulation.

The first principle is that we should start by asking the question, “Do our regulations help meet our fundamental public policy objectives?” It’s important to avoid being wedded to past approaches. They’re simply a means to achieving the goal, not the goal itself. This may seem obvious, but it’s remarkable how often this basic principle is ignored.

I’ve observed the regulatory process, both from inside and outside, for more than twenty-five years. I’d say that most supervisors take the current regulatory framework as a given. Regulatory “innovation” usually takes the form of looking for better ways of applying the current framework. In some cases, regulators are limited by laws they are required to carry out. But in my experience, regulators often can do more to focus on their fundamental goals.

A good example of the “goal-oriented” principle is the movement towards more risk-focused supervision. In the past, supervisory procedures tended to rely on the detailed review of individual transactions and accounts. As technology, globalization, and deregulation have altered the way business is done, supervisors have changed the way they oversee organizations. Examiners no longer exhaustively review all of an organization’s activities. Supervisors are allocating more resources to those activities that pose the greatest risk.

I would note that the Fed has just approved a new risk-focused program for supervising most bank holding companies with assets of less than $1 billion. The program will be implemented no later than the end of this month.

The second principle of effective regulation is that it should be accomplished in the most efficient way possible. What do I mean by this? A regulatory approach is efficient if it accomplishes its goal with the least amount of “collateral damage” to the industry’s activity. In other words, supervisors should use the least intrusive approach to achieve public policy goals. One of the keys to efficient regulation is taking advantage of market mechanisms or using incentive-compatible approaches.

Let me share one example of efforts to reduce the impact of regulation on an industry. As you know, the Fed is revising its Bank FCM inspection procedures. The Chicago Fed has been a lead participant in this effort. These procedures will reduce the potential for duplicate work by having Fed examiners rely, to a greater extent, on the work performed by the CFTC and other regulators, including self-regulatory organizations. The Fed has placed a high premium on ensuring that our inspection procedures retain appropriate responsibility for examining the risk management of the FCM, as well as an assessment of the FCM’s impact on the consolidated organization.

Efforts like these are helping us move towards a more effective use of supervisory resources and greater focus on those practices most likely to affect the safety and soundness of the organization and the financial markets. The procedures are going through final revision at the System level and are currently being used on a provisional basis. I look forward to the procedures full implementation next year.

The third principle for effective regulation is that it should not discourage changes in technology and market structure. Again, this principle seems obvious. Nonetheless, we still see regulatory approaches being used long after they've been rendered obsolete by technological change.

Consequently, regulation should be constructed to be self-evolving. Regulatory change that's dependent on the actions of cumbersome political bodies — either national or international — are generally difficult to implement. It's better to have a structure that's designed to evolve with the industry. This is easier said than done, of course. But it's an important principle to keep in mind.

A good example here is the Fed's position on electronic banking. Clearly technology is drastically changing the way that financial institutions conduct transactions for themselves and for their customers. While there are certain risks involved with the move to a greater use of technology in doing financial transactions, we are committed to letting markets evolve, as long as there is no threat of systemic failure or undesirable risk.

In conclusion, let me note that risk-taking is a critical and fundamental nature of financial markets and the US economy, and each of you plays an important role.

The changing financial environment has presented many new challenges. Many of the same forces that affect your business also affect how regulators conduct their business. I would propose that we keep these three guiding principles in mind when designing regulation:

1. Regulation should be goal-oriented,

2. Regulation should be done in the most efficient manner, and

3. Regulation should not discourage changes in technology and market structure. Adhering to these principles in future legislative and regulatory discussions will help foster the economic prosperity of our nation for many years to come.

Thank you.