ISSN 0428-1276

Economic Commentary

Financial Reform at a Crossroads

by W. Lee Hoskins

Today, 75 years after the founding of the Federal Reserve System and 55 years after the nationwide bank holiday of 1933, financial regulation is once again at a crossroads. The conflict between market forces and regulation has created serious problems that cannot be avoided much longer.

At issue is a very basic question: should we go forward with deregulation, or should we turn back? The answer will have an important bearing on the future structure of the financial services industry. Should we make market forces exert a more powerful influence in the financial sector, or should we reinforce the blanket protections of the regulatory process?

I think the choice should be clear: we should rely on market forces. Relying more heavily on market forces requires sweeping away both mental and institutional cobwebs and making a clean break with the past. A piecemeal approach—responding to immediate problems and pressures—is not likely to get us very far unless we establish economic principles to guide deregulation.

The principles we must dust off to guide deregulation of the financial sector are little different from those at work in other industries. Moreover, applying these principles to the financial industry will require a lot more than simply broadening the powers of banks.

In debating and deciding on the steps to take in deregulating the financial industry, the fundamental goal should be to reinvigorate market incentives and tests of performance in banking and other financial markets. The challenge is to eliminate regulations where possible and to strengthen regulations where necessary, building on market forces rather than overriding or suppressing them.

The Background for Regulation

Government has a vital role in a capitalist economy. A political and legal framework is indispensable for assuring individual liberties and property rights and for setting the rules of the game in which markets operate. Within that framework, owners of capital and labor will direct their resources toward uses where opportunities seem greatest. In general, private decisions made with full comprehension of possibilities for gain and risks of loss will produce the best results.

Regulating some activities and precluding others alters the possibility of gain and the risk of loss, and affects choices with respect to resource use. In a static setting, where entry into closely competing endeavors is expensive, technology is unchanging, and innovation is sluggish, the costs of regulation may seem small or slow to appear, perhaps because they are hidden in public subsidies. In such circumstances, the intrusion of government regulation in the marketplace may be able to achieve politically determined results that otherwise would be missed.

In a more dynamic setting—such as the markets for financial services, where competition has been strong, entry by nonregulated firms has been relatively easy, and technology has been dynamic—the outcome can be quite different, as we are now seeing. Although competition holds down direct costs to consumers, inefficiencies are evident, and through the federal deposit insurance mechanism, risk may well be shifted from private decision-makers to the federal deposit insurance system.

The attention banking has received over the years suggests that banking has always been a special case in which regulation was necessary. Certainly as the word "bank" was used in history, there was something unique about the blend of payment services attached to bank liabilities and commercial lending. Almost from the beginning, banks required special charters from governments. Those charters carried with them restrictions on the way banks could conduct their business. Whether these regulations were initially intended to prevent fraud or to generate government revenues from a state-created monopoly is a matter of debate, but by the time of the founding of the Federal Reserve in 1913, regulation of banks was the accepted practice.

The legitimacy of the case for banking being considered special stems largely from problems with bank runs. When depositors in large numbers simultaneously demanded cash repayment from perfectly sound banks, not enough ready cash was available in the nation to meet the demand, resulting in a crisis. All banks, however well-run, could not convert illiquid assets into cash and had to suspend payments, in violation of the

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terms of their charter, or sell assets at reduced prices, thereby impairing capital and perhaps leading to failure.

The prevention of such financial crises was one of the driving forces behind the creation of the Federal Reserve System—a central bank lender of last resort. The Federal Reserve can prevent the failure of sound banks in a liquidity crisis by supplying whatever amount of new cash is required to allay the fears of frightened bank customers. As recently as October of last year, following the stock-market crash, the Federal Reserve performed this function.

Banking Regulations

Many bank regulations have been justified as a way to assure sound banking practices and to reduce the risk of loss from unsound banks. Bank charters typically called for minimum capital holdings and broad restrictions on portfolios. Since the 1930s, of course, banks have been precluded from certain kinds of activities deemed to be risky, including general insurance and securities underwriting.

Subsequent one-bank holding company legislation loosened some restrictions by permitting a holding company to offer a slightly broader set of products than its bank subsidiary could offer directly. In addition, of course, banks in this country have been almost universally excluded from offering products in, or being affiliated in any way with firms involved in, commerce and industry.

Banks were forbidden by regulation (Federal Reserve Regulation Q) to pay interest on regular checking account deposits or to pay more than a ceiling rate on other deposits. There is still debate about whether the prohibition of interest on regular checking accounts was a convenient device for banks to mute competition, or a serious regulatory effort to avoid price wars that might endanger the safety of banks. The Regulation Q ceiling on other deposit rates became a genuine difficulty for banks when it was set permanently below the analogous ceiling for thrift institutions. It was the removal of this Regulation Q restraint that marked the first significant step in banking deregulation.

Portfolio restrictions, product line restrictions, and interest rate limits have all been defended as a means of assuring the safety of banks by removing temptations to engage in "ruinous competition" or to abuse the deposit-raising power of a bank to fund a non-banking affiliated business. But as the postwar period progressed, it became clear that these restrictions were driving growth and innovation outside the banking system and stimulating growth of nonregulated financial intermediaries. Abetted by Regulation Q and its own federal deposit insurance program, the thrift industry was in a strong position to dominate the competition for savings deposits and the mortgage market.

Because they were unencumbered by interest rate ceilings or costly reserve requirements, money market mutual funds and other new competitors and products grew rapidly in the 1970s, aided by the explosion of computer and telecommunications technology. Similarly, capital requirements, limitations on loans to a single borrower and on the kinds of assets banks could hold, as well as the rate and reserve requirement impediments to financing themselves, all contributed to the rapid development of nonbank and offshore financial markets. By the 1970s the term "nonbank bank" had become firmly established in the vernacular of financial markets. Today, there appears to be almost nothing a bank can do that cannot be done by a nonbank bank, while there remain many things that some nonbank banks can do that banks are not allowed to do.

The intent of bank regulations may have been to ensure safety. Some regulations undoubtedly have worked, but there have been other consequences as well, some of which have worked in the opposite direction. Regulation, by encouraging the entry of nonregulated suppliers of financial services, has driven business outside long-established channels. In some instances risk-taking has been encouraged in banking itself. Overnight financing by large banks in the federal funds and repurchase markets has mushroomed, adding fragility to banking and money markets. Banks, seeking to compete with new entrants, have taken business off balance sheets, with devices such as standby commitments and guarantees adding new elements of risk. In many instances the results have been perverse—regulation has encouraged risk-taking by banks and thrift institutions, especially when taken in conjunction with the federal deposit insurance mechanism.

Deposit Insurance

Federal deposit insurance, which was also adopted in the 1930s, has reduced or eliminated the risk of losses to individual depositors and investors, but at the cost of transferring risk to the deposit insurance system.

Deposit insurance is intended to defuse crowd psychology that might trigger bank runs. Insurance forestalls bank runs by assuring depositors that, whether or not a bank is solvent, deposits are safe. A deposit insurance agency, however, must protect itself from "moral hazard"—the hazard that deposits will be supplied indiscriminately to both solvent and insolvent banks, increasing the probable loss for the insurer. Supervision and regulation of insured banks defends against moral hazard, but as recent events illustrate, the defense has not been effective in preventing losses.

The insurance funds have been financed by a flat assessment on banks and thrifts—a practice that leaves the cost of funds to a bank largely unaffected by the risk profile of its portfolio. All but the largest of depositors can be unconcerned with risk in choosing among small banks. At very large institutions, all depositors and even other creditors believe that they are effectively insured because regulators are reluctant to allow large banks to fail.

Uniform deposit insurance premiums and, until risk-based capital standards are implemented in 1992, uniform capital requirements allow management to avoid some of the real risks of their asset decisions and liability management practices. Deposit insurance has become a substitute for a strong capital base in attracting deposits. Depositors, instead of relying on the strength of the bank, rely on deposit insurance.

The reaction of regulators to the serious financial problems of some thrifts and banks in the 1980s has not helped the incentive problems. In some instances, regulatory standards and accounting principles were relaxed, partly to give financial institutions time to recover their losses and restore their financial health. Postponing closure gave added incentive for shareholders and managers to "go for broke," seeking growth at the expense of asset quality. The guarantees of the insurance program, in effect, prevented the cost of funds from reflecting the full risks of loss and encouraged further expansion.

For whatever reason, forbearance in closing insolvent institutions, relaxed regulatory tests of performance, and debt guarantees to uninsured creditors of banks and bank holding companies have worsened an already difficult situation. Despite six years of a remarkably robust economic expansion, the incidence of troubled institutions has not diminished.

Overall, the present situation is the culmination of long years of regulation. Banks today are no longer the predominant suppliers of financial services. Market forces have eroded any uniqueness of major banking products on both the asset and liability sides. The distinguishing feature of institutions we call banks today is simply the regulatory taxes and subsidies associated with them.

However innocent their beginnings, many banking regulations have inadvertently encouraged risky behavior in the market while transferring the risk to federal deposit insurance programs. Insulating markets by saving shareholders, managers, and uninsured depositors from loss does not solve problems, but only aggravates the condition. If this risk-taking is not valuable in itself, what sense does it make to subsidize it?

The debate about financial restructuring most recently has focused on removing barriers to competition between banks and nonbanks in underwriting securities and insurance. Removing barriers makes good sense. Let the market tell us what will succeed and what will fail.

But there, of course, is the problem. Market tests of gain and loss have been supplemented by a regulatory blanket.

Where to Go from Here

What should our objectives be in restructuring the banking system? What is it we really want to accomplish? We want an efficient, flexible, innovative financial sector that will provide services in a stable environment.

Basic principles of capitalism should be our guide: market forces should determine the outcome, including the blend of financial and nonfinancial products offered by a firm, as well as the risk profile of firms. Market incentives and risk evaluation must include possibilities for gain and the risk of loss and ultimately failure.

If this message could be interpreted as naivete, remember the regulatory problems we have inherited from the past. Surely we need to examine a few alternative approaches.

One response to our predicament would be to make a clean break with the past. To restore market judgment in allocating resources and market resiliency in dealing with strains and shocks when outcomes are bad, we must make basic changes in the regulatory structure—changes that restore incentives for management and depositors alike to avoid problems. The guiding principle in this evolution should be to create opportunities for market tests of gain and loss, and of success and failure. As a practical matter, our choices will be severely constrained by the kind of federal deposit insurance system we choose.

How can we promote the application of market tests when making decisions about the future of deposit insurance? Some suggest that federal deposit insurance should be eliminated, but others argue that would be undesirable, or politically infeasible. Another suggestion is to adopt risk-related deposit insurance premiums. Under this system, the cost structure of financial institutions offering insured deposits would reflect the risk profile of their business. International agreements are currently being reached to do something comparable in setting minimum capital standards.

This approach is consistent with my guiding principle, but its effectiveness in practice is arguable. Risk analysis is inherently complex, and political mechanisms are not noted for their ability to set or change prices in accordance with changes in market circumstances. Some doubt that risk analysis would prevail in setting premiums over outside pressures on the insurance agency.

An alternative (or an adjunct) to risk-based deposit insurance premiums would be more stringent limits on insurance and the enforcement of those limits in practice. If we wish to keep the maximum insurance limit at $100,000, we should limit it to $100,000 per person, not per account. After all, the Federal Reserve can stem a true general bank run by providing emergency liquidity to solvent but illiquid depository institutions.

Enforcing this limit in coverage would increase market discipline on financial institutions by prompting depositors to scrutinize more closely the financial condition of those to whom they have entrusted their funds, and to shift their deposits when risk seems higher than return. In so doing, they force key changes in a bank's operation and capital levels through gradual changes in the cost of attracting deposits. The focus of regulatory resources would be to support these changes by closely monitoring and strongly enforcing capital standards. This approach would require regulators to move aggressively to reorganize or merge the bank before its capital is depleted. Regulatory resources would be shifted away from surveillance and examination of nonbanking activities toward enforcement of bank capital standards.

Greater reliance on market forces would be assisted by making public the condition of financial institutions. This might be as simple as releasing ratings—the kind of report card on each depository institution that regulators now share only among themselves. Keeping information on financial conditions secret prevents market forces from signalling to depository institutions the true costs of their funds. Readily and continuously available information could tend to refocus market judgments, prompting bank managements to redress deficient practices. Of course, some lead time for implementation of such an announcement program would be appropriate in order to allow depository institutions an opportunity to improve their financial condition.

A final approach would be to retain the federal insurance system much as it is today, and to greatly strengthen the regulatory apparatus in order to prevent private risk from being transferred to the taxpayer. This would not be my preferred approach. First, it would extend the range of regulation to a wider and wider set of financial activities as banks and thrifts gain new powers, either by legislation, by court decision, or through technology and new products. Second, the enlarged regulatory effort would continue to push activities outside established financial channels. Finally, I doubt that regulators can, as a practical matter, provide continuous protection against perverse incentives, especially in a setting as dynamic as today's financial markets. The logical outcome of retaining the deposit insurance system in its present form is a substantial step up in regulation.

I am not especially apprehensive about letting market forces operate more fully. Federal Reserve open market operations and the discount window, when properly administered, represent a substantial defense against the classic crowd psychology of a generalized bank run. These central bank tools can provide liquidity freely to markets and to sound institutions, counteracting a crisis. There is a significant body of opinion that the collapse of the banking system in the early 1930s could have been avoided if the Federal Reserve had behaved in the same way it behaved last October.

The Federal Reserve is not, however, a deposit insurance agency. If banks are insolvent, their assets may not be sufficient to withstand a run even when liquefied at the discount window. Regardless of the specific form of the deposit insurance we choose, it would be counterproductive for the Federal Reserve to liquefy insolvent institutions. By so doing, it would enable fleet-footed creditors to get their money, leaving others to absorb all losses. It is not the function of the Federal Reserve to interfere in the distribution of losses among the creditors of an insolvent bank; that is the function of a receivership.

More is at stake here than the reassertion of market tests in banking and regulation, critical though those tests are. The Federal Reserve is a central bank with the unique power to create base money. Liquidity crises are rare. The normal job of the central bank is to supply base money over time at a rate consistent with price stability. The independence of the Federal Reserve within our federal government, the removal of authority to make direct loans to the Treasury, and the limitation of access to the discount window to sound institutions are all vital protections against attempts to divert money creation to uses that would endanger price stability.

Conclusion

The objective for financial reform should be to restructure financial regulations in a way that builds on market forces. Financial reform so far has been less a choice made by Congress and the regulators to seek the benefits of market forces than a result of market forces successfully seeking to avoid the regulatory straitjacket. As I have argued, we are nearing a crossroads.

We must push ahead with financial reform. Obviously, the setting for true financial reform must be changed. The risks of loss in financial decisions must be shifted away from the insurer to those financial managers (and the shareholders they represent) who make the decisions. It will be essential to reestablish the right to fail and the risks of that fate for financial institutions of all sizes and for all uninsured depositors.

Regulatory resources need to be shifted toward maintaining capital necessary to protect the insurance fund. Other changes will be necessary as well. More information about the condition of financial institutions and reductions, or at least limitations, on the amount of deposit insurance are but a few. Such changes may not be popular, but they should be the guiding principle if true financial reform is to continue.

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