

Financial Reform At A Crossroads

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Recent efforts to reform laws and regulations governing the financial services industry remind me of an anecdote. A novice parachutist couldn't open his chute on his first jump. As he was falling toward the ground, he noticed another individual flying upward past him. He called out to the passerby, "Do you know anything about parachutes?" The passerby replied, "No ... Do you know anything about gas stoves?"

I believe that policymakers have reacted to the problems of the financial industry in a similar manner. Instead of taking the necessary precautions before the jump, policymakers have tried to solve problems in mid-flight with new regulations and restrictions. This piecemeal approach of responding to immediate problems and pressures is unlikely to create a flexible and efficient structure for our dynamic financial services industry. In my view, taking the necessary precautions before the jump means establishing economic principles to guide financial reform. The principles should be little different from those at work in other industries, i.e., market forces and incentives. Relying more heavily on market forces, though, requires making a clean break with the past. As we consider legislation to reform the financial services industry, we are idling at a crossroads. One road leads to a reinvigoration of market principles and incentives to guide the industry. The other leads to further reliance on the regulatory apparatus.

My message today is two-fold. First, the laws and regulations governing the financial services industry are in need of a comprehensive reform. Second, this reform should build on market forces rather than override or suppress them. The challenge is to eliminate regulations where possible and to strengthen regulations where necessary.

### Conflicting Goals For Policymakers

This is not to say that government does not play a vital role in the financial services industry or in other areas of our economy. A political and legal framework is indispensable for assuring individual liberties and property rights, and setting the rules of the game for markets to operate. Within that framework, owners of capital and labor will direct their resources toward uses where opportunities seem greatest. Generally speaking, private decisions made with full comprehension of possibilities for gain and risks of loss will produce the best results.

If resources throughout the economy are to flow to activities where they are of greatest value, competitive standards should not differ significantly across the various banking markets or between banking and other industries. Regulating some activities and precluding others alters the possibility of gain and the risk of loss and affects choices with respect to resource use. No central architect designed the regulatory system or laid out a single set of principles. The current banking regulatory system developed primarily in response to financial crises and other historical and political events. As a consequence, bank regulation has been designed to serve goals that often are in conflict with one another.

In general, policymakers have adopted regulations to achieve two major goals. First, policymakers want to avoid extensive losses to depositors. Public pressure to protect depositors' funds grew as banks played a larger role in financial transactions and individuals held a larger portion of their funds in banks. A second goal of policymakers is to create a regulatory framework that encourages efficiency and competition. An efficient financial system will give the consumer the highest quality services at minimum cost.

These two goals can be conflicting. In a competitive environment, risk taking is encouraged and the failure of firms, banks included, is inevitable. In an attempt to protect depositors from financial hardship, however, regulations were adopted that were intended to prevent bank failures. Unfortunately, policymakers ignored important market principles in the construction of the regulatory system. Consequently, our regulatory system itself is responsible for much of the turmoil in the financial industry today.

#### Deposit Insurance

For instance, federal deposit insurance, adopted in the 1930s, has reduced or eliminated the risk of loss to individual depositors and investors. To stabilize the system and protect depositors from "runs" on banks, insurance was established to guarantee the creditors of failed banks against loss. Insurance forestalls bank runs by assuring depositors that their money is safe, whether a bank is solvent or not. At the same time, risk is transferred from bank management to the deposit insurance system.

With respect to the safety of funds, depositors need not worry about the condition of financial institutions. The two federal insurance funds, the FDIC and FSLIC, originally were designed to cover deposits up to \$2,500 (which translates into about \$22,000 today). Over the years, the maximum was raised by Congress to its current level of \$100,000. 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 of the reluctance of regulators to allow large banks to fail. With today's high level of protection, the condition of financial institutions is of no concern to the depositor and creditor.

Deposit insurance also alleviates risk concerns for bank management. The insurance funds have been financed by a flat assessment on banks and thrifts -- a practice which leaves the cost of funds to a bank largely unaffected by

the risk profile of its portfolio. If federal deposit insurance followed the practices of private insurers, banks would be divided by risk characteristics with a deductible and premium established for each division. Moreover, a private insurer periodically examines the behavior of those insured to determine if insurance should be limited or even denied. Incentive problems surface as the real risks of asset decisions and liability management practices are not factored into the cost of insurance. Deposit insurance has become a substitute for a strong capital base in attracting funds.

The reaction of the regulators to the serious financial problems of some thrifts and banks in the 1980s has not helped the incentive problem. 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 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.

#### Banking Regulations

Many bank regulations, justified as a way to assure sound banking practices, also have underestimated the importance of market incentives. Bank charters typically call 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, banks in this country have been almost universally excluded from being affiliated in any way with firms involved in commerce and industry.

Banks were also forbidden 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 the ceiling 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 all have been defended as 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 nonbanking-affiliated business. But as the post-war period progressed it became clear that these restrictions were driving growth and innovation outside the banking system and stimulating growth of non-regulated 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. 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 non-bank and offshore financial

markets. By the 1970s the term "non-bank 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 non-bank bank, while there remain many things that some non-bank banks can do that banks are not allowed to do.

Why have regulations been so unsuccessful in guiding the financial industry? In a static setting where entry into closely competing endeavors is expensive, technology is unchanging, and innovation 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 not be achieved. In a more dynamic setting, such as today's market for financial services, where competition has been strong and technology has grown rapidly, the outcome can be quite different, as we are now seeing.

Regulation, by encouraging the entry of non-regulated suppliers of financial services, has driven business outside of long-established channels. In some instances risk-taking has been encouraged. Overnight financing by large banks in the federal funds and repo 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. To sum up, instead of strengthening the safety of the system and guarding against bank failure, the combination of regulation and federal deposit insurance has encouraged risk-taking in the financial industry.

### Where To Go From Here

Although I have taken issue with our means, our ultimate end has remained the same over the past 200 years. We are striving for an efficient, flexible, innovative financial sector providing services in a stable environment. To get there, 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.

As Congress ponders its agenda for 1989, financial industry issues - the savings and loan crisis, deposit insurance, and Glass-Steagall reform - are at the top of almost everyone's list. Financial reform must be comprehensive, and the first step should be to recognize and resolve the conflict in current public policy goals. Let me now be a little more specific and outline two possible paths for reform - reinvigoration of market incentives or increased reliance on regulation.

### Reform Built on Market Principles

To restore market judgement 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 which 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, success and failure. As a practical matter, our choices will be severely constrained by the kind of federal deposit insurance system we choose. Risk-based Deposit Insurance. 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-based deposit insurance premiums. Under this system, the cost structure of financial institutions offering insured deposits would reflect the risk profile of their business. The implementation of international capital standards would aid a risk-based system, but the effectiveness of such a system in practice is debatable. Risk analysis is complex to begin with 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.

Limiting Deposit Insurance. 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 can't price it, we might limit it. If we wish to keep the maximum insurance limit at \$100,000 we should limit it to \$100,000 per person, not per account. Enforcing this limit in coverage would increase market discipline by prompting depositors to more closely scrutinize the financial condition of those institutions 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 financial institution'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 a financial institution before its capital is depleted. Regulatory resources would be shifted away from surveillance and examination of nonbanking activities towards the assessment of asset quality and the enforcement of capital standards.

Releasing Ratings of Financial Institutions. Greater reliance on market forces would be assisted by making public the condition of financial institutions. This might be as simple as releasing a financial institution's

ratings, the kind of report card on each depository institution that regulators now share only among themselves. Keeping information on financial condition 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.

#### Strengthening the Regulatory Apparatus

The other option is 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, court decision, or technology and new products. Second, the enlarged regulatory effort would continue to push activities outside of established financial channels. Finally, I doubt that regulators can, over time, provide 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.

#### The Central Bank's Role

I am comfortable letting market forces operate more fully. Open market operations and the discount window, 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 to counteract a crisis. There is a significant body of

opinion that indicates 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 in October 1987 following the stock market crash.

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 liquified at the discount window. Regardless of the specific form of deposit insurance we choose, it would be counterproductive for the Federal Reserve to liquify insolvent institutions. Doing so 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.

There is more 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 fiat 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

Our objective 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 straightjacket.

We are at a crossroads. We must push ahead with financial reform. The risks of loss in financial decisions must be shifted from the insurer to financial managers and the shareholders they represent. In doing this, it is essential to re-establish 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 towards maintaining capital necessary to protect the insurance fund. Other changes will be necessary, too -- provision of more information about the condition of financial institutions and reductions, or at least limitations, on the amount of deposit insurance are but a few.

Piecemeal solutions are politically appealing due to the conflicting public policy goals. However, a comprehensive solution based on market principles is our only hope for true financial reform.