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FINANCIAL REFORM: ASSESSING RISK, STRUCTURE, AND REGULATION

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Good afternoon ladies and gentlemen. As a closing speaker at a multi-day session, I am always a little anxious about the attendance, especially in such a beautiful resort as the Greenbrier. So, I was relieved and, to be honest, feeling a little smug when I saw the size of today's turnout; that is, until I learned about the wonderful drawing for prizes and the condition that you must be present to win.

It's always a pleasure to speak to such a distinguished group as the Community Bankers of Pennsylvania. Pennsylvania community banks are well-managed, so I don't have to spend time stressing the importance of the fundamentals of banking; this group understands and practices them well.

Rather, I would like to talk about the need to reform the financial industry. Basic regulatory reforms are needed to encourage a more resilient and, therefore, a more stable industry in a fast-paced, global financial market. We can no longer rely on the system of rules and regulations that has governed the industry since the Depression. We must allow market forces to guide the industry.

It is my intent today to outline three key reforms necessary to reestablish market forces in the financial services industry. First, federal deposit insurance must be limited. Second, government authorities must pursue supervisory policies and practices rather than regulatory ones. Third, we should separate the deposit insurance function from the financial institution supervisory function.

The Current Debate

Reform of the financial services industry has become a hotly debated issue in the 1980s. There is a growing realization that our bank and thrift regulatory systems are in need of reform. Private sector estimates of the cost of cleaning up the thrift industry alone are over \$124 billion, or over \$1,000 per tax return.¹ What's more discouraging is that, without reforming the current system, it is entirely possible that the U.S. taxpayer will confront future bailouts comparable to the present thrift crisis.

The recently passed Financial Institutions Recovery, Reform, and Enforcement Act of 1989 (FIRREA), partially deals with the fiscal and regulatory aspects of the thrift problem by committing \$50 billion in new money to close, reorganize, or recapitalize the insolvent portion of the thrift industry. Sadly, FIRREA does not undertake fundamental reform of our regulatory framework in ways that will increase the efficiency and long-run stability of the banking system and, in turn, protect the public purse from losses generated by insured financial institutions.

Reformers can be separated into two camps. One camp proposes an increased role for regulation to limit bank powers and activities. This means a reduced role for management discretion, shareholders' control, and market discipline. Proponents of "reregulation" base their reforms on a belief that in banking, market solutions are dangerously unstable. In their view, increased regulation protects the public purse from losses by prohibiting banks and thrifts from participating in activities that are deemed "excessively risky." I believe advocates of increased regulation are misguided in their notion that financial markets left to their own devices are inherently unstable. In fact, I believe the current thrift situation is evidence that attempts to increase the short-run stability of the banking system through regulation gnaw at efficiency and undermine the long-run stability of the banking system.

I belong to the camp of reformers that would rely on market forces to shape the structure of the financial services industry. The driving force in any reform package should be the reestablishment of the risk-return trade-off in financial services. This means that those who benefit from the upside gains of risky strategies would be the same ones who would bear the downside losses when such strategies do not pan out. The linchpin to a well-functioning financial industry is a reduction in the scale and scope of federal deposit insurance. This reform and the others I will talk about would reinvigorate market forces, and thereby increase the efficiency and long-run stability of the banking system.

Why Markets?

Markets provide us with the best allocation of resources and hence, the most efficient solution. Although fears of instability are often the pretext for regulation, I would argue that market solutions will lead to greater stability. In practice, markets have worked extremely well in providing goods and services in a variety of industries. Market-oriented economies have outperformed, and continue to outperform, centrally planned economies. Even the world's stalwarts of intervention -- the Soviet Union and the People's Republic of China -- are looking toward the reestablishment of markets in their economies.

In the United States, the trend during the late 1970s and early 1980s was one of deregulation, including deregulation of the oil and gas, communications, and transportation industries. Deregulation in this country cannot necessarily be attributed to the ideological leanings of the Reagan Administration, since its impetus began during Jimmy Carter's term. Nor can the deregulation of the U.S. economy and the world economy in general be attributed to the desire of governments and bureaucracies to give up economic

or political power. Instead, I believe that deregulation is due to a growing recognition that markets produce the most efficient and stable outcomes. Furthermore, in an increasingly integrated global marketplace, competitors must be acutely aware of the needs of the marketplace to survive. Similarly, if our financial industry is to prosper into the twenty-first century, we must do away with costly market insulation.

Regulation and Its Costs

Why are regulated firms unable to compete with the unregulated? Regulated industries are unable to react flexibly and efficiently to change. Regulated systems like our current banking and thrift industries, are less capable of adapting to shocks or changes in markets, like the inflation of the late 1970s, the disinflation of the 1980s, technological changes, or the entry of unregulated producers. Instead of market-driven changes in resources and operations, the result often is unforeseen changes in the size and mix of regulatory taxes and subsidies. Existing regulations often become less effective or even counterproductive. In the financial industry, subsidies inherent in fixed-rate deposit insurance, free finality of payments over Federal-Reserve-operated wire transfer systems, and access to discount window credit increase in size because depository institutions change their business practices to take more advantage of them.

Not surprisingly, the response of regulated systems to external shocks usually is to attempt to alter the mix of regulatory taxes and subsidies to accommodate the shocks. The regulatory response usually lags developments in the marketplace and is typically piecemeal. Usually, it either validates market innovations or reregulates areas where market forces have made existing regulations obsolete. This may include instituting new regulations designed to limit or prohibit new activities that are deemed "too risky" (for example,

thrifts' investments in junk bonds); removing regulations that are no longer enforceable or too costly to continue (for example deposit rate ceilings); or, modifying existing regulations (for example risk-based capital standards for banks and RAP accounting standards for thrifts). We have seen in the financial industry that the regulatory response is to deal with the symptoms of the shock without allowing the system to adjust fully to the shock. More often than not, our policies tend to protect the regulators' weakest clients at the expense of both the efficient firms in the industry and the stability of the banking system. The current thrift industry collapse is the most recent and prominent example of this flaw in a system of strict regulation.

Inevitably, the costs of regulation escalate, and, as the thrift situation indicates, unless the costs are dealt with promptly, they can become uncontrollable. Regulatory interventions in the banking system have created an environment in which market forces are ignored so often that profits are difficult to achieve within the limited scope of activities that the regulators are willing to permit. Consequently, increased subsidies become necessary to permit regulated entities to compete with unregulated interlopers. As the taxpayers of this nation are witnessing, it becomes very costly to continue to protect the regulated. In addition, the presence of the subsidy adds to the temptation for political interests to treat regulated entities as public utilities and assign them a laundry list of social objectives -- CRA lending guidelines and lifeline banking, as examples -- regardless of whether or not the businesses can make a profit doing so. The inevitable result is the relative decline of the regulated sector as more efficient unregulated entities attract customers away from regulated firms.

We have seen this trend in the banking industry since the early 1960s. Advances in communications and computer technology have increased the efficiency of financial markets and fostered the development of new

unregulated products, such as money market funds, which are substitutes for traditional banking products. Technological innovation coupled with the inflationary pressures of the 1970s and early 1980s eroded, and in some instances completely broke down, the barriers between banks, thrifts, and other providers of financial services. Furthermore, with the globalization of financial markets, U.S. banks met increasing competition from foreign banks in the international and domestic markets. Increased competition from both foreign banks and nonbank providers of financial services has reduced banks' share of the financial services market from 36 percent in 1974 to 27 percent at the end of 1988. Total share of the financial services markets accounted for by banks and thrifts combined peaked at 55 percent in 1974 and fell consistently throughout the 1980s to 44 percent in 1988.²

Perhaps the most dramatic example of the ultimate shrinkage of the regulated sector is the current restructuring of the thrift industry. The thrift industry will most likely shrink by at least one-third in the next couple of years as the insolvent portion of the industry is shut down. The increased efficiency of secondary mortgage markets and competition from mortgage brokers in primary mortgage markets seem likely to further diminish the size of the current thrift industry as the spread between the cost of funds for thrifts and what they can earn on their mortgage portfolios narrows further. This squeeze on thrift earnings is intensified by provisions in FIRREA that restrict or prohibit thrift investments in potentially profitable areas like high-yield corporate bonds, and require thrifts to keep 70 percent of their assets in mortgage-related assets.

Market-Based Reforms

Market-oriented reform of the regulatory structure is necessary to ensure a stable, efficient financial industry and to guard against future multi-billion-dollar rescues. To restore market discipline as an integral

part of the supervisory and regulatory structure we must develop a supervisory tolerance for allowing banks of all sizes to fail. This is important, because failure is the mechanism through which the market corrects persistent and substantial inefficiencies and is a sure-fire way to reduce the subsidy associated with the federal safety net.

Using market discipline to replace regulation has many benefits. First, it increases the effectiveness of bank supervision. The perverse incentives for regulators to adopt politically motivated forbearance policies are minimized. Specifically, market discipline serves as a check on the overall supervisory process and it reduces the probability of regulatory capture by large and politically influential firms in the regulated industry. Second, by reducing access to funds, markets naturally curb the growth of weak institutions and quickly force the closure of insolvent institutions.

Although the market is sometimes a harsh regulator, market forces discriminate among institutions according to relative risks and not on the basis of size or charter type.

One caveat to note is that the reforms that I propose assume the industry to which they are applied is healthy. This is especially true for deposit insurance reforms. Obviously this is not the case today for either the banking or the thrift industry. Therefore, I make these recommendations under the presumption that a transition period is utilized to recapitalize, reorganize, or close insolvent and unsound institutions. FIRREA is an important first step in this direction. However, considerably more needs to be done before a comprehensive package of deposit insurance and regulatory reforms can be implemented.

Deposit-Insurance Reform

Key to any market-oriented system is extensive reform of federal deposit insurance. The degree to which we implement fundamental reforms to federal deposit insurance will determine the nature and scope of reforms to the remaining regulatory structure. Restoring market discipline as an effective constraint on bank and thrift activities is the main purpose of deposit-insurance reform. This entails changes in the coverage and pricing of federal deposit guarantees to eliminate or reduce the degree to which the taxpayer subsidizes risk-taking by financial institutions.

To restore proper discipline to an institution's shareholders and managers, federal deposit insurance coverage must be limited and correctly priced. At the very least, the current statutory limit of \$100,000 per insured deposit account at each insured bank should be strictly observed. All institutions, regardless of size or charter type, must be closed when they are found to be insolvent, and deposit insurance coverage must not be extended in any circumstance to explicitly uninsured depositors, unsecured creditors, and stockholders.

Strict enforcement of the present limit would require some changes in the failure-resolution policies of the Federal Deposit Insurance Corporation (FDIC). By seeking to minimize insured deposit payouts, uninsured claimants are protected, a practice which eventually evades market discipline and, as we are seeing now, greatly increases long-term uninsured claims exposures. Furthermore, strict enforcement of the deposit insurance ceiling would ensure the equitable treatment of uninsured depositors and other creditors of failed institutions regardless of size or type of charter. In fact, any legislative

reform of deposit insurance must also come to grips with the "too big to let fail" doctrine to ensure that all institutions are treated equally. Such changes would restore some measure of market discipline to banking and would give the "too big to let fail" doctrine the burial it deserves.

However, to truly reap the benefits of deposit-insurance reform, I believe that we must reduce the statutory limits to levels significantly below the current limit. In establishing the new limit we should explicitly decide what is the purpose of deposit insurance. It seems to me that the purpose is to provide a certain amount of protection to depositors. It should not be to provide competitive advantages to one class of providers of financial services. A significant reduction in coverage would be quite consistent with depositor protection, reduced subsidies to regulated firms, and reduced liability for taxpayers. One possibility would be to reduce the limit from \$100,000 to, for example, \$25,000 per account, indexed to the Consumer Price Index (CPI). Such a reduction in coverage would be consistent with the desire to provide a safe haven for the savings of the majority of this nation's citizens while reestablishing large depositors as a form of discipline on risk-taking. After all, \$25,000 today adjusted for inflation in the CPI is roughly equivalent to the \$2,500 limit originally established in 1934. Moreover, the average insured deposit account in both banks and thrifts is only about \$8,000.

If greater coverage were desired, a coinsurance feature could be added for additional deposit balances above the \$25,000 ceiling. For example, the FDIC could provide 90 percent coverage for balances up to \$50,000, 80 percent coverage for balances above \$50,000 and less than \$100,000, and 70 percent coverage for balances exceeding \$100,000. Private insurance markets might develop to provide coverage for the coinsurance deductible portion of the

deposit for those depositors who desire 100 percent protection. Furthermore, depositors with balances in excess of \$10,000 already have access to U.S. Treasury bills, which are close substitutes for federally guaranteed bank deposits for liquidity purposes.

Supervision, Information, and Prompt Closure

Instilling more market-driven incentives into the financial industry requires a sharp break in tradition for both government authorities -- like the FDIC, the Comptroller, and the Federal Reserve -- and you -- the managers of the financial industry. Rather than imposing unconditional limits on the judgment of managers, government authorities should further reduce regulation and loosen the regulatory reins on managers. Under this approach, managers and shareholders alike would be forced to more carefully weigh risks and share in the outcomes of their decisions. The ability to attract and maintain deposits will emanate from successful business decisions, not a deposit insurance subsidy from the taxpayers.

For you, the decisionmakers of the industry, this type of world means less security provided by the government than in the past. While, on the surface, this may appear disruptive and uncomfortable, there are longstanding gains for you, your industry, and society. These reforms encourage a more stable and more efficient financial services industry than we have today.

The appropriate role of government authorities in this reformed world is to distill the numerous, often specific body of regulations into a few financial condition standards, such as capital requirements. The regulator would monitor and supervise firms to insure that the prescribed financial condition guidelines were being observed. As long as the institution met the guidelines, restrictions on behavior would be minimal.

A good example of such a supervisory policy might take the form of a three-tier system of standards and restrictions. Institutions meeting the highest financial condition standards would operate without any restrictions from the supervisor. Oversight would be limited to detecting fraud and other irregularities in the bank's operation, and collecting and disseminating information. Institutions falling short of the standard would be subject to restrictions. Institutions that failed to meet some defined minimum financial condition standards would be given 90 days to recapitalize and reorganize or be closed or sold by the supervisor.³

Central to this supervisory approach and increased market participation is the timely dissemination of information. A prime concern of the supervisory authority would be to assist investors and savers by providing adequate information for informed decisionmaking. Examination ratings, cease and desist orders, supervisory agreements, and other regulatory actions should be published by the supervisory authority. In addition, audits by independent accounting firms should be required for all financial institutions, although the frequency might also depend on how well-capitalized the institution was.

Supervisory authorities, in turn, need timely, accurate information to be able to identify and close troubled institutions. Closure or the failure of institutions carries negative connotations, but what does failure actually mean? It doesn't mean that the physical assets disappear, but that the failed institution's resources are put to more efficient uses. Permitting banks to fail can strengthen the banking system and the nation. First, the very possibility of bank failure provides strong incentives to bank management to follow sound banking practices. Second, the reality of a bank failure is a powerful reminder to others. Finally, liquidation of a bank prompts the reallocation of scarce labor and property resources to more efficient uses, and removes the need for taxpayer subsidies to prop the bank up.

Separating Supervision and Insurance at the Federal Level

My final proposed reform is to separate the insurance and the supervisory functions. This is necessary to ensure prompt closure of insolvent institutions, and it serves as a check on overall regulatory laxity. By separating the insurance function from the supervision function, we remove possible conflicts of interest between those two functions. For example, under the present system the deposit insurer could adopt a policy of capital forbearance to cover up its own supervisory errors. As an insurer, the deposit insurance agency should have the strongest possible incentives to maintain the value of its insurance fund. I suggest that insurers not supervise, and that they have greater control over the terms and conditions under which they would offer deposit insurance.

In addition to separating the deposit insurer from supervisory responsibilities, the use of the deposit insurance function as a check on overly permissive supervision, and on regulatory forbearance policies, requires some basic changes to the deposit insurance function. First, the deposit insurer must have the right to immediately terminate insurance coverage for new deposits when it determines an institution is being operated in an unsafe and unsound manner. Second, the deposit insurer must have the ability to charge differential premiums to institutions based on risk, including regulator risk. The deposit insurer could even factor into its pricing decisions the loss experience associated with each regulator, thereby establishing a pseudo-market price for regulatory services. Banks and thrifts would factor the deposit insurance premium differential into their decision when choosing a supervisory agency. Unfortunately, some of these changes run counter to the provision of FIRREA which increases the supervisory responsibilities of the FDIC.

Conclusion

The enormous cost of the thrift bailout and the record number of thrift and bank failures in the past several years is evidence that our financial regulatory system has not resulted in a highly efficient and stable financial services industry. Our current system of regulatory taxes and subsidies is unworkable, and likely to become more so, as innovative bankers manage to extend the deposit insurance subsidy to new products and needs. It is time for us to make a choice between a regulatory structure that relies more heavily on markets or one that relies on bureaucratic rules and political judgments. For me, the choice is clear: if we want an efficient and stable financial system and want to avoid FSLIC-type bailouts in the future, we must choose a market-oriented solution.

To achieve a more responsive market-oriented regulatory system I have advocated a number of reforms including:

- Reducing the cost and the scope of deposit insurance to minimize the transfer of risk to the deposit insurance system and to taxpayers.
- Relying on supervision, dissemination of information, and prompt closure of institutions instead of increased regulation.
- Separating the deposit insurance and supervisory functions.

Reforms such as these will help us achieve our goals of long-run efficiency and stability of the financial system and will protect the taxpayer from future loss.

Footnotes

¹ The \$124 billion includes \$50 billion for prior case resolutions and \$74 billion for restructuring insolvent thrifts. The \$124 billion estimate does not include financing costs of \$81 billion (\$150 billion) if the spending is financed over 10 (30) years at current market interest rates. See Barbara Pauley, "The Thrift Reform Program: Summary and Implications," New York: Soloman Brothers, April 1989.

² The financial services market is defined here as the total credit market debt claims against domestic nonfinancial sectors. See W. Lee Hoskins, "Reforming the Banking and Thrift Industries: Assessing Regulation and Risk," 1989 Frank M. Engle Lecture In Economic Security, presented to the American College, Bryn Mawr, Pennsylvania, May 22, 1989, Table 1.

³ A similar proposal can be found in George J. Benston and George G. Kaufman, "Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Options," Staff Memoranda 88-1, Federal Reserve Bank of Chicago.