FEDERAL RESERVE BANK
OF CLEVELAND

CLEVELAND, OHIO 44101
AREA CODE 216-579-2000

February 26, 1990

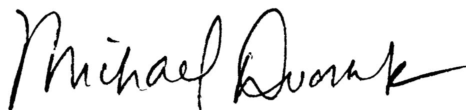
Natalie B. Baumer
Senior Editor
Warren, Gorham & Lamont, Inc.
One Penn Plaza
New York, New York 10119

Dear Ms. Baumer:

I have enclosed Mr. Hoskins' article, "The Fountain of Youth: Market-Oriented Reform of a Tired, Old System," to be published in an upcoming edition of The Bankers Magazine. We appreciate the opportunity to submit Mr. Hoskins' views on the regulatory reform of the financial services industry.

If there are any problems or questions please do not hesitate to call. I can be reached at 216/579-2033.

Sincerely,



Michael Dvorak
Public Affairs Advisor

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

THE FOUNTAIN OF YOUTH: MARKET-ORIENTED REFORM OF A TIRED, OLD SYSTEM

W. Lee Hoskins

U.S. banks face strong competition from domestic nonbanks and from foreign banks. Legislative proposals for restructuring the financial system have proliferated in the past decade, and are likely to be considered again, in response to both market pressures and to current conditions in the banking and thrift industry. As we consider possible changes, it must be recognized that a delicate tradeoff exists between the scope of the federal safety net and the socialization of the financial services industry. In return for virtually unlimited access to the deposit insurance fund, the financial industry will be subjected to more regulation. Recent experience makes us acutely aware of the dangers of providing too large a safety net. In such a system, the financial exposure of taxpayers is at the mercy of bank managers. Moreover, managers of regulated institutions are handicapped in competing with unregulated providers of financial services, often putting the taxpayers at greater risk.

Fundamental reform of the financial services system is past due. The recently passed Financial Institutions Recovery, Reform, and Enforcement Act of 1989 (FIRREA) deals only partially with the fiscal and regulatory aspects of the thrift problem. Unfortunately, FIRREA does not come to grips with the fundamental reform needed to increase the efficiency and long-run stability of the financial services system. Reform, necessary to ensure a healthy and stable financial services industry, must be founded on market principles. The marketplace should determine the blend of financial and nonfinancial products offered by firms, as well as the risk profile of firms.

At the heart of any scheme to reform the regulatory framework of our financial services industry is a comprehensive reform of the deposit insurance system. Only then can burdensome rules and regulations be reduced, allowing market forces to play its appropriate role. Moreover, these reforms would avert the continuation of an ever-expanding set of public and social responsibilities imposed on the banking industry.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Rationale for Deposit Insurance

Federal deposit insurance has distant and controversial origins. After 150 legislative proposals dating back to 1886 and prompted by the banking crisis of the Depression, Congress enacted the Banking Act of 1933, which established the Federal Deposit Insurance Corporation (FDIC). Support for federal deposit insurance was predicated on the notion that banking was inherently unstable.

This new system of deposit insurance at the federal level was not without its critics. Opposition to deposit insurance centered on two issues: it would prove to be exceedingly costly; and, it would unfairly subsidize poorly managed banks. Initially, even President Roosevelt shared these oppositions to the idea, reportedly stating that it would never work. Perhaps not so surprisingly, these arguments are still with us today.

Deposit insurance was originally introduced at the state level to protect communities from abrupt fluctuations in bank deposits or in other currency-like instruments due to bank failure, and to protect individual depositors against catastrophic loss. Over the years, the major purposes of deposit insurance have changed. Deposit insurance no longer is needed to prevent systemic bank runs or to protect the medium of exchange from calamitous events such as the failure of a large bank. Instead, the Federal Reserve's open market operations and lender-of-last-resort powers are sufficient to guard against systemic risk. The remaining rationale for federal deposit insurance is to protect small depositors by providing protection for their transactions accounts and savings. Policymakers must ask themselves whether the current system of deposit insurance and the attendant system of regulations is the most efficient way to protect depositors.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Costs of Banking Regulation

Inseparable from any system of deposit insurance is an intricate system of regulations designed to protect the insurance fund and, ultimately, the taxpayer from loss, and to guard against the unfair subsidies to poorly managed banks feared by early critics. Unfortunately, the regulations and restrictions have become an operational handicap for the regulated industries in a fast-changing world such as ours.

Why are regulated firms unable to compete with those that are 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 to changes in markets, such as 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 and in access to discount-window credit increase in size because depository institutions change their business practices to take better advantage of them.

Not surprisingly, the usual response of regulators to external shocks is to attempt to alter the mix of regulatory taxes and subsidies to accommodate the shocks. The regulatory response is often piecemeal and lags developments in the marketplace. Typically, it either validates market innovations or reregulates areas where market forces have made existing regulations obsolete. The regulatory response in the financial industry has focused on the symptoms of the shock without allowing the system to adjust fully to the shock. More often than not, 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, as the current thrift-industry collapse indicates.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A Regulated Industry in a Changing World

But why did the system, which seemed to work well for the first 30 years, break down over the last 30 years? 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. 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 international and domestic markets. Increased competition from both foreign banks and from 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.

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, such as high-yield corporate bonds, and require thrifts to keep 70 percent of their assets in mortgage-related assets.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

How to Fix the System?

As policymakers consider packages of reform, there are two general directions from which to choose. One direction is simply the same one in which we have traveled since enactment of the sweeping banking legislation of the 1930s. In short, we have supported an expansive system of deposit insurance and other so-called "safety net" measures that, consequently, have required further reliance on the regulatory apparatus. Continuing in this direction will lead to continued handicaps for traditional providers of financial services. The other direction, one that I believe would offer substantial benefits and reduced costs, relies on market principles to guide industry evolution.

Key to any market-oriented reform of the regulatory system is an extensive overhaul 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, eliminating or reducing the degree to which the taxpayer subsidizes risk-taking by financial institutions.

Deposit Insurance. 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. Strict enforcement of the present limit would require some changes in the failure-resolution policies of the FDIC. By seeking to minimize insured deposit payouts, uninsured claimants are protected, a practice that eventually evades market discipline and, as we are seeing now, greatly increases long-term uninsured claims exposures.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

To truly reap the benefits of deposit-insurance reform, I believe that we should reduce the current statutory limit with a co-insurance deductible on balances that exceed some specified maximum amount. The guide to setting the new limit should be to provide a certain amount of protection to small depositors. It should not be to provide competitive advantages to one class of providers of financial services. A reduction in coverage would be quite consistent with depositor protection, reduced subsidies to regulated firms, and reduced liability for taxpayers. As policymakers consider the appropriate maximum level of deposit insurance coverage, they should keep in mind that the $2,500 limit originally established in 1935, adjusted for inflation, is roughly $25,000 today. Moreover, the average insured deposit account in both banks and thrifts is only about $8,000.

Closure and the "Too Big To Fail" Doctrine. 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.

Closure or the failure of institutions carries negative connotations, but what does failure actually mean? It doesn't mean that the physical assets disappear; rather, it means that the failed institution's resources are put to more efficient uses. Permitting banks to fail can strengthen the banking system. The very possibility of bank failure provides strong incentives to bank management to follow sound banking practices, and liquidation of a bank prompts the reallocation of scarce labor and property resources to more efficient uses, removing the need for taxpayer subsidies to prop the bank up.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Supervision and Information. Instilling more market-driven incentives into the financial industry requires a sharp break in tradition for both government authorities -- like the FDIC, the Comptroller of the Currency, and the Federal Reserve -- and 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 to share in the outcomes of their decisions. The ability to attract and maintain deposits will emanate from successful business decisions, not from a deposit insurance subsidy from the taxpayers.

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

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.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Central to this supervisory approach and increased market participation is the timely dissemination of information. A prime responsibility 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 is.

The Sooner the Better

Some critics argue that the current condition of the thrift and banking industry is too fragile to support reform, but prolonging the problem will not make it any easier. Inevitably, 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 regulators are willing to permit. Consequently, increased subsidies become necessary to permit regulated entities to compete with unregulated interlopers.

It is time to cut our losses and restore the health of the financial services industry. FIRREA is an important first step in this direction, but it is not enough. Real reform begins with a reduction of the federal safety net accompanied by a reduction in burdensome regulations. Only then can market forces play a larger role.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis