

Suggested Outline for  
Western Pennsylvania League of Savings Institutions (April 4)  
Executive Briefing Program, University of Pittsburgh (April 5)

I. Introduction

- A. Today I want to talk to you about 2 legislative issues facing the Federal Reserve System
  - 1. Regulatory reform of the financial services industry
  - 2. Monetary policy that strives for zero inflation
- B. Legislation over the past decade has attempted to deregulate and level the playing field between the regulated and non-regulated
  - 1. Depository Institution Deregulation and Monetary Control Act of 1980
  - 2. Garn-St. Germain Act of 1982 -- added powers to thrifts
  - 3. Competitive Equality and Banking Act of 1987 -- closed the nonbank bank loophole in the Bank Holding Company Act
  - 4. Several other proposals sought to expand general powers that have been out of legal bounds since Glass-Steagall some 50 years ago
- C. Recent thrift crisis has made more people realize that fundamental regulatory reform of the industry is necessary
  - 1. Goals, most people agree
    - a. efficient financial services industry
    - b. minimizes risk to taxpayers
  - 2. Need to firmly establish market-based principles
    - a. reform of deposit insurance system
    - b. burdensome rules and regulations should be minimized
    - c. do away with the "Too Big To Fail" doctrine

II. Deposit Insurance System & Regulation

- A. Rationale for deposit insurance
  - 1. Federal deposit insurance has a long and controversial history
    - a. legislative proposals date back to 1886
    - b. over 150 proposals introduced until finally enacted in the Banking Act of 1933
    - c. took the banking crisis of the Great Depression, but only accepted hesitantly
  - 2. Initial fears, eventually panned out in the last decade
    - a. thought that it would prove to be exceedingly costly
    - b. unfairly subsidize poorly-managed banks
    - c. even FDR said, "the minute the government starts to guarantee bank deposits, it will run the risk of a probable loss."

3. Deposit insurance was introduced at the state level in early 1800s
  - a. to protect communities from abrupt fluctuations in bank deposits (economic disturbance)
  - b. to protect individual depositors from catastrophic loss
  - c. however, it was never clear that this system was needed to protect from bank panics or runs (even if it was, the Fed can use open market operations and the discount window)
  - d. so, it seems that reform must center around how much protection we want to afford depositors and how much exposure we want to subject taxpayers
- B. Negative Effects of Deposit Insurance
  1. intricate system of rules and regulations to protect the insurance fund (taxpayers) and to guard against unfair subsidies to poorly managed banks
  2. proved to be operational handicaps in a fast-paced world
    - a. technology allowed unregulated interlopers to unfairly compete
    - b. fluctuations in inflation highlighted the inflexibility of a rigid system of rules and regulations

### III. Price Stability and Sound Banking

- A. Credit analysis
  1. decisions to limit bank risk are based on
    - a. the value of collateral in secured loans
    - b. and on projections of the ratio of a borrower's current assets to current liabilities in unsecured loans of working capital
  2. unexpected price changes can invalidate assumptions underlying the loan; the standards of loan evaluation can be preserved under conditions of price stability
- B. Price instability
  1. accounts for many of the problems of financial institutions here and abroad, but also for the plight of U.S. deposit insurance agencies
  2. price fluctuations of the late 1970s and early 1980s coupled with the regulatory environment and deposit insurance limits of \$100,000 per account encouraged the system to undertake greater risks
    - a. bank managers and shareholders are not penalized for poor management since depositors are all but unconcerned with risk
    - b. insurance is not priced for risk (flat fee)
    - c. the manner in which deposit insurance agencies settle failures, guaranteeing non-insured parties not included under the deposit insurance system, tends to worsen already apathetic market pressures
    - d. problems are compounded by the incentives of managers, once an institution is in trouble, to take greater and greater risks

#### IV. Deposit Insurance Reform

- A. To restore proper market discipline, federal deposit insurance coverage must be more correctly priced or limited
- B. There are numerous proposals to limit the insurance
  1. at the very least, \$100,000 per account should be strictly observed -- protection should not be extended to uninsured claimants when handling a failure
  2. at the Cleveland Fed, we believe that the current statutory limit should be reduced
    - a. for those who desire more protection, co-insurance could exist above the limit
    - b. the Banking Act of 1933 included a permanent plan for co-insurance that was never instituted
    - c. a reduction would be quite consistent with the major objective of insurance -- protection of depositors from catastrophic loss
      1. the \$2,500 limit that was originally enacted (1934), is worth about \$25,000 when adjusted for inflation today
      2. moreover, studies at the Cleveland Fed indicate that the average insured deposit account in both banks and thrifts is only about \$8,000

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

- A. Strict enforcement of the deposit insurance ceiling means that we do not extend insurance to uninsured depositors and other creditors
  1. exceptions are not made for size of institution or type of charter
  2. in particular, the "TBTF" doctrine must be done away with
- B. Failure of any organization carries many negative connotations, but what does it really mean?
  1. does not mean that the assets disappear
  2. assets are relocated and put to more efficient use
  3. existence of failure removes the need for taxpayers to prop up an unhealthy institution
  4. threat of failure strengthens market forces and discipline

#### VI. Loosening of the Regulatory Reins

- A. Only after reform of deposit insurance and the allowance of failure for badly-managed institutions can market incentives be expected to perform
- B. Only then, can managers in the financial services industry be freed from restrictive rules and regulations
  1. managers and shareholders alike would be forced to more carefully weigh risks and share in the outcomes of their decisions
  2. the ability to attract and maintain deposits would be based on the quality of business decisions, not on a deposit insurance subsidy of taxpayers

- C. Role of government authorities would change
  - 1. would not be an enforcer of rules and restrictions, but monitor and supervise in order to ensure that prescribed financial condition guidelines were being observed
  - 2. 3-tier system
    - a. institutions meeting the highest financial condition standards would operate without any restrictions on their activities
    - b. institutions falling short would be subject to some restrictions
    - c. those institutions that failed to meet some minimum standards would be given 90 days to recapitalize and reorganize or be closed by the supervisor
  - 3. government authorities would not only supervise, but would also help disseminate information so that markets can make well-informed decisions

## VII. Conclusion

- A. Comprehensive reform should be undertaken soon
  - 1. we will never find the "best" time to institute reforms
  - 2. present state of thrift industry should not deter efforts
- B. Reform should be based on re-installation of market forces
  - 1. deposit insurance limited
  - 2. "TBTF" doctrine done away with
  - 3. regulations loosened
- C. Fed can contribute to sound financial services industry by adopting a monetary policy that pursues zero inflation

## Suggested Opening for Western Pennsylvania League of Savings Institutions

Good evening. It is a pleasure to be part of the Western Pennsylvania League of Savings Institutions tonight.

A number of years ago, my (pick relation) told me that there are 3 things in life that you should never do.

1. Never eat at a place called Mom's.
2. Never play cards with a guy called Doc.
3. And, never talk to a league of savings institutions about limiting federal deposit insurance.

(after the laughter settles) I know this is why you invited me to speak. Tonight I would like to discuss with you regulatory reform of the financial services industry.

## Suggested Opening for the University of Pittsburgh Executive Briefing Program

Good afternoon. It is a pleasure for me to come back to the Joseph M. Katz Graduate School of Business at the University of Pittsburgh.

It has been a little over two years since I left Pittsburgh and the private sector and entered the arena of public policymaking as president of the Federal Reserve Bank of Cleveland. As students in a graduate school of business program, you are taught how to recognize and satisfy the needs and desires of the marketplace in an efficient manner. Managers can make better, more efficient decisions when policymakers allow market forces to allocate our resources and guide decisions.

This is often a difficult rule to follow when making economic policy because human nature often makes us believe that the world functions in a predictable manner and we -- policymakers -- know what is best.

This attitude reminds me of the captain of a ship on a foggy night who sees a light in the distance that appears to be in the way of his course. He signals, "Change your course 10 degrees to the south."

A signal comes back, "change your course 10 degrees to the north."

The angry captain responds, "I am a captain, change your course 10 degrees to the south."

The signal comes back, "I am a seaman first class, change your course 10 degrees to the north."

The captain, very angry at this point, sends back, "I am on a battleship, change your course 10 degrees to the south."

The reply, "You better change your course, I am in a lighthouse."

Let's stick to what we know, and what the eastern bloc seems to be learning; that is, an economy based on market principles works most efficiently. Today, I would like to talk about two areas that the Fed can influence to help markets work more efficiently: regulatory reform of the financial services industry and a monetary policy that pursues zero inflation.