

Remarks by

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## INTRODUCTION

Thank you for that kind introduction and warm reception. Having lived in Pittsburgh for 5 years, I always welcome the opportunity to return and see old friends.

It is indeed a pleasure for me to be able to address this Annual Convention of the Pennsylvania Bankers Association.

One of the Convention organizers told me that the purpose of inviting me here was to "**help bring down the wall between bankers and their regulators.**" Of course, given some of the things that I've heard that commercial bankers are saying about regulators these days, maybe I'd be safer staying on the other side of a wall.

Actually, I do want to help bring down that wall by giving you some of my views on government regulation in general, and regulation of banks and other financial institutions in particular.

When I think about the inherited approaches to supervision and regulation of the financial services industry in this country, I think about what was going on on the other side of another wall---the Berlin Wall---before it was dismantled in 1989. I once heard an interesting description of the way the communist system worked. The trouble is, I don't know whether it is Stalinism or Maoism that is more similar. In the Soviet system under Stalin, Communism meant a very long list of activities that were

prohibited to the average citizen. In contrast, under Mao Tse Tung, Communism meant a very short list of activities that were permitted to the average citizen.

At other times, I think about the things that regulation does to commercial banks--especially smaller banks--to promote "safety and soundness" as being like what was said during the Vietnam war: namely, "***we had to destroy the village in order to save it.***"

The permission, denial, and instructional approach to regulating depository institutions, versus the information and disclosure approach to supervision of non-depository institutions, has given us a wealth of experience. It is time we started to apply some of what we have learned.

There are only two ways to distribute what an economy produces: the political system and the market system. When something is not working as well as desired, there are two approaches to fixing the problem:

- (1) increase the role of government in the economy; or
- (2) improve the workings of markets.

It is my view that dissatisfaction with the performance of the financial services sector of our economy in recent years stems from too large a role of government, rather than too little involvement. The gist of my remarks to you this morning is that we should be exploring ways to enhance the incentives and the discipline of market forces, and shrink the role of the government.

**MARKET SYSTEMS, CENTRAL PLANNING, REGULATION, AND ADAM SMITH**

The United States is the most prosperous nation on earth. We have achieved and maintained that status not because we have more natural resources, not because we have a more powerful army, not because our children are brighter or our businesses more clever than elsewhere in the world. We have done so because, more than any other nation in history, we have relied on market mechanisms, despite their imperfections, rather than on political decisions, to allocate our productive resources.

Many contend that Germany and Japan--our current rivals for economic pre-eminence--have managed to close the economic gap through industrial policies and managed trade, which we should now imitate. While both of these countries have made advances, arguably with more government involvement than the United States, I question the now fashionable conclusion that industrial policy and managed trade are the sources of their success. No one seriously suggests that the United States should follow industrial policies like those of Britain and Sweden, or the managed trade policies of the former Soviet bloc. I suggest, therefore, that the post-war advances in both Germany and Japan have more to do with the willingness of their people to embrace economic liberalism and to compete vigorously on a global scale than with their governments' involvement in markets.

Adam Smith, the world's first major writer on economics, long ago pointed out the benefits of self-regulation and the folly of governmental regulation. His words, written more than 200 years ago, are still applicable today. *"The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it."*

Despite Smith's warning, the belief persists in many places that government involvement in regulating markets is a necessity. Government regulation of an industry is much like government planning for an economy. It is a very common approach, but it is also a very inefficient approach.

The current economic plight of the nations that tried the hardest to plan their economies -- the former Soviet Union and the nations of eastern Europe -- is dramatic evidence that planning by a government agency is grossly inferior to the planning that comes about when each individual and firm is free to make its own plans, and prosper or fail based on the degree to which they produce something of value to society. Over long periods of time, western nations have tended to prosper to the extent that

they refrain from government regulation and planning, that is, refrain from using the force of the state to overrule the plans that individuals and firms make for themselves.

The fall of the Berlin Wall, in November 1989, has made it possible for all the world to see just how much superior the market system is to a system in which there is extensive government regulation of economic activity. Prior to 1945, the eastern sector of Germany was little different from the western sector. Both used the same language, both had the same culture and history, both had been depleted by war, and both had similar levels of infrastructure, industrialization, literacy, and worker skills.

Over the next 45 years, however, one sector relied on central planning and government control to direct economic activity while the other relied primarily on markets for that task. The difference in outcomes, of which you are well aware, was much more dramatic than even free-market advocates had expected.

#### **MARKET FAILURES AND GOVERNMENT FAILURES**

The case for relying on private markets rests not on an argument that private markets function perfectly, but on the proposition that failures within political institutions pose a far greater threat to our personal freedom and to our economic achievements than the failures of private markets.

Economists refer to cases where markets don't work perfectly as *market failures*. Some people argue that market failures can be corrected by government involvement in the economy, through regulation and income transfers.

There are many levels on which one can challenge the policy prescription of government regulation and intervention in the economy. However, their greatest shortcoming arises from their idyllic view of governments and the political process. They portray the government as an omniscient referee that acts only in the face of specific and identifiable market failures to maximize the nation's collective welfare. The government then imposes taxes, subsidies, and regulations that correct the particular market failure, without creating distortions elsewhere in the economy.

These are not realistic assumptions about the nature of democratic processes. Economists refer to violations of these assumptions as *government failures*.

So, the relevant question is: would substituting government failures for market failures make us better off?

Economic policies implemented by governments inevitably redistribute income. Consequently, the influence of rival interest groups, not arguments about economic growth or average standards of living, dominate policy making in elected democracies. Regulations and government interventions persist because they confer substantial

financial benefits on certain segments of society. This is why, for example, the investment banking industry lobbies against any easing of Glass-Steagall restrictions on investment banking activity by commercial banks. Many government regulations and restrictions benefit some at the expense of others, with a net loss to all because of the induced economic inefficiencies.

Both the gainers and losers have incentives to organize. When a society demonstrates a willingness to allocate resources through the political arena instead of through the market, individuals are encouraged to reduce their investments in private economic activities and to increase their investments in political speculation. Through this unfortunate arbitrage, our nation is eventually made poorer.

#### **THE HIGH COST OF BANK REGULATION**

Let me shift now from these broad principles and turn specifically to banking regulation. The cost of compliance with regulatory requirements includes both the explicit costs of meeting regulatory requirements, and the implicit costs imposed by regulatory prohibitions. Both costs are large, but are often overlooked in the heat of concern about bank safety. Indeed, it sometimes appears that there is now zero tolerance for losses to the Bank Insurance Fund, rather

than a sense that the costs of losses should be weighed against the costs of avoiding losses.

In addition to the costs of complying with regulations, there are costs to banks and to the economy of prohibiting banks from engaging in certain activities and offering certain products. Those costs are hard to measure, and while no estimates of such costs are available, they are likely to be substantial. When restrictions on banks cause their balance sheets to have less product, geographic, and industry diversification, their soundness and profitability are reduced.

There is a cost to the public of providing to depository institutions the subsidy implicit in the federal safety net. The safety net is comprised of federal deposit insurance, access to the Federal Reserve discount window, and Federal Reserve provision of intraday credit through its operation of the nation's payment system.

This subsidy, and the consequent web of regulations, causes some people to think of banks differently than they think of most other private firms. Banks have even been likened to persons on welfare -- as long as they are receiving the subsidy implicit in the federal safety net, they must do what government tells them to do.

Representative Henry B. Gonzalez, Chairman of the House Banking Committee, has said that *"When you're on relief, there are lots of rules. Just ask the poor folks on food*

**stamps."** A variant of this view is that banks should be treated as public utilities. Consequently, some people want to treat the banking system as an instrument for achieving social and political goals. They see banks as a vehicle for getting access to financial resources through the political process rather than through competition for funds based on the merit of the investment. One example is the call for a national investment policy that was heard a few years ago. Another is the efforts of consumer-oriented individuals or groups, using leverage provided by the Community Reinvestment Act (CRA), to reach agreements with banks to make loans or investments favored by those groups. Sometimes such efforts result in a less-efficient allocation of scarce resources. The morally valid objective of the CRA -- to assure equal access to credit by all members of our society -- can be impeded when the requirements for complying with the act become an instrument for seeking resource redistribution that was not intended by the act.

#### **REGULATORY DISTINCTIONS ARE NEEDED**

In my view, what is missing in bank supervision and regulation is a sufficient distinction between well-capitalized, well-managed institutions and marginally-capitalized, inadequately-managed institutions. New powers and exemptions from some regulations can be granted to the strongest institutions while still achieving the aims of

legislation. An appropriate distinction would take a triage approach, as follows:

1. Banks that are terminally ill should be closed promptly lest they needlessly absorb scarce examiner and deposit insurance fund resources. The FDICIA (Federal Deposit Insurance Corporation Improvement Act of 1991) took important steps in this direction with its prompt corrective action requirement that closes banks whose capital-to-assets ratio falls below two percent.
2. Banks that clearly are healthy should be exempted from much "safety and soundness" regulation, lest they needlessly absorb scarce examiner resources, and waste their own resources complying with regulations that are inappropriate for banks in their condition.
3. The sick, but potentially viable, banks are the ones where supervisory efforts should be focused, to try to restore them to health and to prevent them from sliding into the terminally ill category.

Unfortunately, current supervisory policy has regulators treating healthy banks essentially the same as banks that are sick, but potentially viable.

**SOME PROPOSALS FOR REDUCING REGULATION**

Regulations imposed with even the best of intentions entail substantial costs, many of which are unintended. The costs of complying with regulation constitute a tax on the business of banking. As with all taxes on business, the true burden is shared by investors in the form of reduced market valuations of their investment, by employees in the form of lower real wages, and by customers -- in this case in the form of higher interest paid on loans and lower interest received on savings. Also, whatever natural comparative advantage depository institutions have in delivering intermediary services is diminished, and businesses and households suffer a reduced menu of financial services. Indeed, the entire economy is harmed to the extent that regulation reduces the efficiency of the financial system and therefore the real growth potential of the economy. Even when regulation is appropriate, its form may matter a great deal.

Recently, I proposed several specific ways to modify the current regulatory system, with little or no new legislation, that make greater use of market forces to achieve legitimate regulatory goals while reducing compliance costs. Harnessing market forces for regulatory purposes will reduce costs because markets are much more efficient at modifying banks' behavior than regulators could ever hope to be.

To some people, the concept of market forces regulating an industry sounds like an oxymoron. They ask, "**Doesn't regulation have to be carried out by a regulator, by a government agency?**" Indeed not. Market forces are very powerful and very efficient regulators.

My proposals provide incentives for every bank to become a member of a group of banks that are especially well-managed and well-capitalized. This approach creates a process for reducing the cost of complying with bank regulation both directly, as banks earn their way into a "quality club" of financial intermediaries, and indirectly, as the need for regulation is reduced by a decline in the risk to the Bank Insurance Fund and taxpayers.

If you want the details of my proposals you may contact the Public Affairs Department (216/579-3079) at the Federal Reserve Bank of Cleveland and ask for a copy of the paper. The paper is titled "**A Market Approach to Banking Regulation,**" and was presented to the Cato Institute's Annual Monetary Conference on March 18.

Banks are subjected to a wide array of regulations intended to achieve a variety of purposes. For example, the Internal Revenue Service requires reports on interest paid to and received from bank customers to facilitate and encourage compliance with tax laws; the Treasury Department requires reports of large currency transactions to help detect illegal activities; and agencies that provide

government guarantees on loans require special documentation for those loans to protect the government's interests. Some regulations require banks to inform customers of bank practices, some are intended to protect mortgage applicants and other borrowers, and some seek to foster bank "safety and soundness."

The broad array of regulations can be divided into four categories: (1) those intended to provide the government with some information about its citizens; (2) those intended to lower the costs of information to customers of depository institutions; (3) those intended to achieve some social/political goals; and (4) those intended to facilitate maximum long-run sustainable growth.

My proposals concern only that portion of bank regulation that is intended to foster safety and soundness so as to achieve the highest rate of growth that is sustainable in the long run. Within that limited scope, my proposals will move the bank regulatory system closer to the Securities and Exchange Commission's (SEC) information and disclosure approach to supervision, which I believe is more efficient than the permission, denial, and instruction approach to regulation that is the norm in banking.

These two regulatory systems are, in essence, competing with each other through the firms that they affect -- banks on the one hand and nonbank financial services firms on the other. If the bank regulatory approach burdens banks more

than their competitors are burdened by the SEC approach, after taking into account the benefits that banks get from the federal safety net, banks will be at a cost disadvantage in offering financial services to customers. Firms not subject to bank regulation will use their cost advantage to entice customers away from banks. Thus, bank regulation generally will not prevent customers from obtaining financial services, but will increase the likelihood that those services will be obtained from nonbank financial services firms.

The proliferation of alternatives to banks in recent years suggests the SEC approach is superior and that a shift of sources is occurring. The increasing availability of bank-like services from finance companies, mutual funds, brokerage houses, and insurance companies suggests that the regulated depository institutions are holding on to a shrinking share of the intermediary services market.

Economists don't lament sourcing shifts caused by differences in the efficiencies of suppliers, but shifts that result from government-imposed handicaps waste scarce resources. Therefore, it would be in the public interest if more efficient regulatory methods were adopted to achieve the legitimate aims of bank regulation, while relying on natural comparative advantage to determine the outcome among equally-supervised competitors.

## CONCLUSIONS

In summary, the cost of complying with bank regulation is high, making it important to find ways of reducing that cost while still achieving appropriate regulatory goals.

Market forces can be used to lower the costs of regulation while enhancing the achievement of the regulatory goals of ensuring safety and soundness and fostering an efficient banking and payments system. Those improvements will help achieve greater efficiency and growth for our economy.

Markets, like political systems, do not function perfectly, but markets--unlike political systems--offer the only game in which all can be made better off. This is not a theoretical point, but an observation on history.

An efficient financial system is of the utmost importance to an economy. With this in mind, it is clear that steps taken to increase the market-determined stability and efficiency of the financial system can be steps toward a more prosperous economy.