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Criteria for Evaluating Proposals Affecting the Financial Industry

keynote address by
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Ohio Banking Mid-Winter Meeting
Ohio Bankers Association
Community Bankers Association of Ohio

11:00 a.m.
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Hyatt on Capitol Square
Columbus, Ohio

NOTE: The bankers' focus in this meeting is **governmental affairs** and establishing contact with legislators. Jerry has only **15 minutes** for his speech, which will be followed by Q. and A. The news media will be present, and some might be carrying Jerry's speech on live video.

I. Introduction (very briefly)

  A. Acknowledge introduction.

  B. I always welcome opportunities to meet with Ohio's bankers.

  C. I have only 15 minutes, so let me get right to the point.

II. The Fed's Purpose (very briefly)

  A. As we look ahead into the 21st century, we face an increasing pace of change in banking technology, and the almost certainty of banking legislation.

  B. Change requires strategic thinking, which requires a firm grasp of purpose.

  C. The Fed's purpose is to promote maximum sustainable increases in the standard of living. It is to maximize the wealth of the American people.

  D. The Fed is **not** in the business of trying to make **some** people better off at the expense of others. We are **not** in the business of redistributing income.

III. How the Fed Promotes Growth

  A. The Fed's three main activities -- monetary policy, payment system services, and supervision and regulation -- each contributes to the efficiency and potential economic growth rate of the American economy.

B. How does monetary policy increase wealth?

1. Stable purchasing power fosters efficiency and growth because:

   a. It reduces uncertainty about the dollar outcomes of current business decisions.

   b. It reduces the resources Americans waste in devising protections from inflation.

   c. It reduces the resources wasted by having to use a shrinking unit of measure.

   d. It avoids the discouragement to saving and investment caused by interaction of inflation with the tax code.

2. It is incorrect to say the Fed restricts growth to prevent inflation. That has it backwards. Actually, we restrict inflation to **facilitate** growth.

C. How does supplying payments services increase wealth?

1. Nationwide clearinghouse.

   a. This has been a necessary service with our massive geographic area and fragmented banking system.

   b. It remains to be seen whether this service will always be needed from the Fed.

2. Final settlement facility.

   a. The Fed's currency and deposit facilities are this nation's means of final settlement of all money transactions.

   b. It is hard to imagine a monetary economy without the efficiency of a common vehicle for settling transactions, and with the demise of gold, the Fed's money is all there is.

3. Discount window.

   a. Try to imagine the unnecessary chaos that would result without this safety net for banks that miscalculate or have technical problems that would prevent them from settling with us at the end of a day!.

4. Finally, our hands-on knowledge of the payments system helps equip us to deal with emergencies.

D. How can supervision and regulation possibly promote greater wealth?

1. It is all too obvious to everyone that bank failures are not good for growth. Past problems in the thrift industry and some regional banking problems, like Texas banks in the 1980s, underscore the importance of supervising the "safety and soundness" of the financial services industry.

2. However, we have also learned that deposit insurance and the discount window's lender of last resort facility both create a moral hazard. If depositors needn't worry about the safety of their deposits, banks needn't worry so much about their liquidity and capital adequacy.

   a. Combatting this moral hazard takes the form of supervision and regulation.

   b. Given that we have to supervise, we seek to do it in a way that adds value to banks.

IV. Criteria for Evaluating Proposals Affecting the Financial Industry

A. Governmental relations is the focus of this Ohio Banking Mid-Winter Meeting. There is much discussion in the halls about proposals that would affect the financial industry. How does the Fed's purpose relate to all of that?

B. We in the Cleveland Fed evaluate proposals that would affect the financial industry from a perspective that is determined by the Fed's fundamental purpose of promoting a rising national standard of living.

C. I think the following four criteria are consistent with that perspective:

1. Does it respect private property rights?

   a. Respect for private property is a fundamental requirement for fostering effort, saving, and investment.

2. Does it promote efficiency through fuller reliance on market forces?

   a. After all, it is market forces that drive prosperity.

3. Does it promote (or avoid stifling) innovation? This criterion really has two aspects:

   a. Promoting **competitive** innovation.

   b. Reducing incentive for **regulatory avoidance** innovation.

4. Does it minimize moral hazard?

   a. Perhaps some moral hazard is inevitable. Nevertheless, it should be minimized so that there is less need to try to offset it.

D. No doubt there are additional criteria -- such as clarity, feasibility, costefficiency, constitutionality, etc. -- that will sometimes become particularly relevant to an analysis of a proposal. But, the four criteria that I have set forth seem most often to be those that help me evaluate how a proposal is likely to affect national prosperity.

V. Applying my Four Criteria to Some Current Issues

A. Glass-Steagall repeal or reform.

1. Repeal or reform seems to be on the horizon.

2. Private property rights -- not affected.

3. Competition -- enhanced.

4. Innovation -- reduces need for regulatory avoidance innovation, and spurs positive innovation.

5. Moral hazard -- moral hazard of deposit insurance would be increased if banks merge with securities houses.

6. So the key question is how can we get the benefits of Glass-Steagall repeal or reform without aggravating our problem with moral hazard?

7. Another issue: Suppose, as I would hope, the current arrangement continues for the Fed to supervise and examine the largest bank holding companies, and those companies acquire securities houses. There is a need to revise the approach to supervision to one or the other portion of these companies.

a. Permission and denial is the tradition within banking supervision:

do only those things for which you have explicit permission.

b. Securities houses have operated within SEC supervision, which takes the opposite approach: do what you want, as long as your reporting provides adequate disclosure.

B. Derivatives regulation and/or supervision.

1. Many are calling for regulation of derivatives. One form of regulation would limit types and uses. A different form of regulation would promote full disclosure of risks.

2. Private property rights -- Regulation that limits the availability of derivatives would reduce people's opportunities to offset risks to their property, as well as reducing their opportunities to put their property at risk.

3. Competition -- we have competition now. Regulation would stifle competition if firms are discouraged from offering or using derivatives.

4. Innovation -- limits would encourage regulatory avoidance, and discourage positive innovation.

5. Moral hazard -- the problem with derivatives is similar to the problem with other lines of banking business -- derivatives can put the deposit insurance fund at risk, and they add to the difficulty of determining capital adequacy.

C. Reform of bank regulatory agencies and structure.

1. Private property rights -- enhanced if we establish one primary regulator

per institution.

2. Competition -- hurt if it becomes more difficult to get a bank charter because the number of chartering authorities is reduced -- but not hurt if the dual banking system is maintained.

3. Innovation -- hurt if the number of regulatory authorities is reduced or if the dual banking system is ended.

4. Moral hazard -- no effect.

D. Political use of banks to "do good." (Or, as agents of social change.)

1. Sometimes banks are seen as tools available to be used for achieving what some believe to be "good works."

   [NOTE: If you need an example, I'd suggest the proposal for "life-line" checking accounts from a few years ago--the idea that banks should provide free checking accounts to customers too poor to pay the regular fees. I'd argue that if a legislature believes the poor are "deserving" of a checking account, then the service fees for those checking accounts should be paid by tax revenues, not bank stockholders.]

2. Private property rights -- violated.

3. Competition -- anticompetitive -- requires services that are not justified by normal market considerations.

4. Innovation -- produces innovation for regulatory avoidance.

5. Moral hazard -- increases the risk to the deposit insurance fund by requiring activities that reduce bank profitability.

E. Use of market forces in bank regulation and supervision. Moving away from the permission, denial, and directive model and toward the SEC-type information-disclosure model. *NOTE: This topic is also included in section V.B.7 above. If you addressed it there, you should skip it here.*

1. Private property rights -- enhance by giving greater freedom to use private capital.
2. Competition -- increase by making banking a more attractive business to enter.
3. Innovation -- increase positive innovation; reduce regulatory avoidance innovation.
4. Moral hazard -- ??

VI. Conclusion

A. As you can see, one or more of my four criteria are particularly relevant for evaluating each of the proposals that I have discussed.

B. The financial services industry has been changing and will continue to change, perhaps even more rapidly. In the midst of change, you and I need touchstones and guideposts to help us keep our bearings, and to help us to think strategically. To aid my strategic thinking I keep the Fed's primary purpose in mind and I use my four criteria to help me evaluate proposals for change. I hope that your strategic thinking is also aided by your own personal touchstones.