Short version used as the speech

REGULATION AND THE FUTURE OF BANKING

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The future of banking cannot be discussed without talking about regulation. This is not simply the assertion of a regulator who views his job as indispensable. In fact, a nationally known banking consultant recently told me that, with my anti-regulatory mind-set, he couldn't understand why I didn't resign.

Regulation *must* be part of the discussion simply because regulation is what has defined banking as we know it. For over 60 years, the Glass-Steagall Act has defined what a banking organization has been allowed to do; the Douglas and other bank holding company acts have defined the corporate form required to do it; the national or state banking authorities, deposit insurance agencies, and Federal Reserve have defined how to do it; and their supervisors and examiners have made sure it was done that way. It's a tribute to the perennial optimism of human beings that a

conference on the future of banking might talk about anything *other* than regulation.

Actually, the reason we can discuss the future of banking without focusing entirely on regulation is that the highly segmented and fragmented financial structure of the 20th century simply will not serve the financial services needs of the 21st century. The power of private property rights operating through a market economy is that, if consumers want something and are willing to pay the price, producers will find a way to supply it. Regulatory restraints impede market adjustments to shifting demands and emerging technologies. Ingenuity will ultimately get over or around regulatory barriers, but it will take time and will absorb resources. In short, regulation "gums up the works." In the end, regulation will not prevent producers from satisfying consumers' desires except at the margin, where higher costs and prices convey the burden of regulation to the consumers who must bear it.

I am optimistic enough about our political system to believe that, if a regulation is not producing some benefit commensurate with the burden it imposes on consumers, such regulation eventually

will be removed -- if not erased, then at least not enforced. Therefore, the place to start envisioning the future regulatory environment of banking is to ask what kinds of regulations are we likely to see.

The questions I want to explore are, what kinds of regulation will be necessary in the future, and how fast we might expect to move from today's outmoded regulation to a future in which regulation makes more sense?

Regulation of Old

The regulations that are viewed as necessary depends on the prevailing conceptions about the stability of a competitive system. We currently are in an era of deregulation. We must not forget that this distaste for regulation reflects a change in thinking from earlier times. In particular, the 1930s were probably the hey-day of government attempts in many nations not just to regulate, but to control the allocation of resources.

Those days are gone. After 60 years, few people believe that governments bring about better economic results than private markets. Nation after nation has repudiated, wholly or in large

part, both the intellectual conceit and the operational reality of state planning and control of the economy. The tide has turned decisively in favor of reliance on decentralized, market-driven economic systems based on individual freedom and private property rights.

In the United States, of course, we never went as far toward a planned economy as most other nations. Nevertheless, maybe simply in reaction to the outrage of the Great Depression, the 1930s were America's high tide of government attempts to manage the allocation of resources, including financial resources.

There has been a worldwide collapse of government efforts at central planning. The world is moving, sometimes with shocking speed, to market-based economies. What I want to emphasize today is that, at least in the financial sector, the United States remains ensnared by the outmoded regulatory framework of the 1930s.

Regulation Today

Our current regulatory framework was designed under emergency conditions -- conditions of economic depression that we all hope henceforth

will be irrelevant. More important than the depression economy, the regulatory framework was created on the crest of an intellectual and political wave that believed governments knew best, that government intervention could make the world better by planning and controlling economic activity. This wave now has crashed, freeing hundreds of millions of people around the world to bask or bake on the sun-drenched beaches of private initiative and private markets -- *except* in our financial sector.

Arbitrary legislative and regulatory rules still attempt to distinguish among major financial industries. The effect of these distinctions was to create and keep separate, three financial market boxes -- labeled 'depository institutions', 'securities underwriting and sales', and 'insurance underwriting and sales.' In principle, each of these gigantic boxes could be subdivided into constituent compartments: Depositories included separate compartments for commercial banks, savings and loans, mutual savings banks, credit unions, and industrial banks; the securities industry might be subdivided into brokerage firms, securities dealers, mortgage companies, and finance companies;

insurance included brokers, dealers, underwriters, and rating agencies.

As long as all these compartments were non-competing markets, regulators could try to enforce different rules within each box. With little danger of substitution, the costs of regulation could be added to price in one compartment without many customers fleeing to other compartments. Regulators' rules could be defined to secure a public purpose superior to the results of unregulated competition within each compartment.

Today, these Glass-Steagall regulations still force firms to fit themselves into one box only, though not necessarily into a single compartment of that box. Regulations still are designed as though firms do not compete with firms in other boxes and compartments as they all cater to the common needs of their common customers.

Regulation in the Future

Sometime in the future, these arbitrary regulatory boxes will be thrown away. Much of the natural product and customer differentiation that separated markets 60 years ago has disappeared, eroded by changing technologies and changing

consumer desires. Regulators and legislators have battled to preserve the old regulatory structure, but they haven't kept up with the pace and extent of erosion. Over the years, any natural walls separating financial compartments largely disappeared, leaving increasingly flimsy partitions made of regulatory restrictions whose only purpose was to maintain tidy compartments.

Three kinds of restrictions have been used to construct these flimsy partitions: restrictions on price, restrictions on location, and restrictions on product. Other than usury ceilings, price restrictions no longer are important in banking. At one time, Federal Reserve Regulation Q set differential maximum interest rates on bank and thrift institution time and savings deposits so that banks would not drain deposits from savings and loan associations when interest rates were rising. By the late 1970s, Reg Q had become the proverbial finger in the dike separating banks from thrifts in deposit markets until the dike finally was dismantled in the 1980s in compliance with the Monetary Control Act.

Statutory prohibition of interest payments on demand deposits was introduced in 1933 to prevent

bank failures due to destructive competition among commercial banks. The prohibition remains in place, but neither logic nor history makes a convincing case for prohibiting interest on demand deposits in a competitive setting.

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Regulatory restrictions on location also are a dead issue for the future of financial services. When national banks were created, starting in 1863, they were not permitted to branch at all. In 1927, the McFadden Act allowed national banks to branch within their headquarters city until 1934, when they were allowed to branch within state to the same extent as state chartered banks. The holding company form of organization provided an effective way to overcome interstate branching restrictions, accounting for as much as 15% of the nation's banking assets as early as 1929, and about 90% recently. Now, under the provisions of last year's Riegle bill, almost-universal interstate branch banking will be possible and seems likely after 1997, unless an unexpectedly large number of state legislatures vote to opt out.

The end of product restrictions is near. A principle argument for separating commercial from investment banking was that, if combined, banks

would use their underwriting business to repackage their bad loans as bonds, which they then would foist off on a gullible public. Neither logic nor historical evidence supports this argument. Customers are not gullible dupes, and a bank's long-run investment in reputation is not worth throwing away for any short-term profit that might be gained from selling bad bonds.

The 1930s' regulatory approach in banking requires companies to ask permission whenever they want to change what they are doing. Banks have needed permission to branch, permission to merge, permission to form a holding company, permission to acquire a subsidiary or affiliate. The underlying philosophy of the regulators was, and remains, "Prove to us that you should be allowed to do this."

I have a fundamental philosophical objection to this approach. It places in administrators of government agencies a power outside the constitutional checks and balances among the legislative, executive, and judicial branches. Constitutionally, as I understand it, government is supposed to bear the burden of proof if private citizens are to be constrained from following the

dictates of self-interest. Instead, banking regulation forces private citizens to bear the burden of proof that they be permitted to act in their own self interest.

Looking at the matter from a more pragmatic angle, what could be more stultifying than subjecting innovators to regulatory discipline before allowing them to face market discipline? We should put the shoe on the other foot. Adopt an information approach. Notify regulators of an innovation, then let them take the initiative to stop it if they are capable of demonstrating that the costs exceed the benefits. Let the public record and accounting statements reveal what firms are doing and how well they're performing in the market. This is not heresy -- other nations do it in banking, and, in this country, regulators outside of banking do it. We're not in the 1930s; let producers take responsibility for what they do.

The future is likely to include firms that combine banking, securities, insurance, and perhaps even commercial activities. How successful these conglomerates will become is uncertain -- only experience can tell us that. Certainly, the expectation is widespread that removing artificial

regulatory restraints will reduce costly inefficiencies or, what is probably the same thing, increase "scope synergies" A number of large, competing financial firms is likely to form a kind of nationwide backbone of financial service suppliers. That backbone will be supplemented in crucial ways by various niche suppliers of specialized services and by a blanket of independent, full-service community banks. Community banks will prosper on the strength of close knowledge of their local markets and an ability to tap the latest technology through correspondent banks and independent servicing companies. Everyone will be made better off through lower costs and a wider field for innovation.

Doing away with Glass-Steagall boxes will not clean the future regulatory slate. Legislation and regulatory rule-making always have played a significant role in American economic life. One way to view some of these intrusions into otherwise private market interactions is as a set of explicit "truces" that stabilize tensions among competing interest groups in the body politic. In the sphere of banking, dual chartering is one of these time-

honored arrangements. The future will still need these intrusions as they continue to mediate tensions among the 50 states, between states and the federal government, and between powerful corporations and the various governments.

Restrictions on location may be gone, but dual chartering will not be a dead issue, because it serves a useful purpose in mediating the banking aspects of states rights issues. For that reason alone it should not be expected to go away. In addition, dual chartering can promote regulatory competition, useful in restraining short-run regulatory excesses and errors, as well as providing an institutional basis for piecemeal innovation.

Functional Regulation

It is less obvious what to expect about so-called "functional regulation" in the future. Functional regulations are those rules unique to each of the Glass-Steagall boxes and compartments. Examples are SEC shelf registration in the securities box, reserve requirements in the banking box, and policy reserves in the insurance box.

Restricting ourselves to banking, you can see examples of the natural death that befits any regulation whose cost exceeds its benefit. Reserve requirements can be expected to be eliminated. Developments in computer technology have made them progressively cheaper to avoid. They represent an inefficient tax on the banking system, and they are an increasingly significant competitive distortion in global banking markets since banks of other nations now operate without such requirements.

Don't assume, however, that reserve requirements will simply disappear without some offsetting change in the account relationship between banks and the bankers' bank. After all, depository institutions cannot expect to use their transactions accounts at the Reserve Banks without maintaining some kind of cash balance or collateral position that would protect a Reserve Bank's interests in the event of a default.

Regulation and Moral Hazard

It might be nice to stop here saying that we canlook forward to an unregulated financial services industry in the 21st century. The reason I cannot stop with that is the same reason that

Congress has had such difficulty adopting financial reform legislation.

Moral hazard is the problem. It is created by the federal safety net, including Fedwire finality, the discount window, and deposit insurance. The financial structure of the future will depend largely on what is done about moral hazard. Banks' transactions deposit liabilities are a primary medium of exchange in our economy and a primary store of value in our financial system. Businesses with access to these last resorts are better credit risks than those without access. Lenders who give credit to those with access need not be as painstaking in their credit evaluations and/or can lower the risk premium they demand when lending, because they are aware that the safety net is available. In these ways, the safety net subsidizes borrowing and risk-taking by those with access. The federal government, in proffering the safety net, thereby stimulates the very risk-taking whose potential result their facility is designed to absorb.

Much of banking regulation today is called prudential regulation, including reporting and being examined for capital adequacy and management

competence. The rationale for prudential regulation is widely understood as a 1930s' assertion that government knows better than the market.

The tough problem is how to remove restrictions between the payments business of banking and all the other businesses in which an unfettered conglomerate firm might want to engage. How can banking become part of everything else without, at one extreme, removing the safety net subsidy, or, at the other extreme, extending both the safety net subsidy and prudential supervision to everything else? Between these two extreme solutions are some more familiar suggestions:

- Proponents of "narrow banking" would charter specialized, safe banks, allowed to invest only in cash and other ultrasafe assets and would issue monetary liabilities. All other financial and nonfinancial business would be conducted from firms with no safety net available to them.

- Advocates of firewalls aim at a similar result. Some proposals, such as that of Jim Leach, chairman of the House Banking

Committee, would allow both bank and nonbank subsidiaries within a financial services holding company. Only the bank subsidiary would have access to the safety net, with limitations on overlapping personnel and intersubsidiary transactions to limit spillovers of the safety net subsidy to other lines of business.

- Other proposals, associated with the current administration and the Comptroller of Currency, would rely on the formation of bank subsidiaries, rather than on holding-company affiliates, to carry on the nonbanking activities of a conglomerate firm. How this proposal would deal with moral hazard has not been made clear.

- Coinsurance is a feature that could be combined with others. This would pull back from 100% insurance of deposits within the current $100,000 per account limit. Instead, starting at zero or more, depositors would absorb a portion of any loss. The benefit would be to reintroduce into deposit markets some of the discipline that safety net

guarantees have removed. Rather than being a matter of indifference, depositors would have a stake in monitoring banks and in distinguishing better-run from less-well run banks. Rather than all banks paying comparable rates for deposits, risk premia would be expected to develop, removing some of the subsidy offered by access to the safety net.

How Soon Is the Future?

It is said that this is the year for financial reform legislation. Of course, such things have been said before, but all we saw was piecemeal change, not thoroughgoing reform. Last year's interstate branching legislation was perhaps the most substantial change since Glass-Steagall.

I'm not going to bet my life on it, but I do see reasons for thinking that the current Congress will enact more complete reform legislation. A number of powerful forces are at work that, in combination, suggest to me that something *must* happen, and soon.

First, banks, their competitors, and their customers are in process of planning for the new

interstate banking environment of 1997. To plan effectively, they need either affirmation that existing regulatory ground rules will not be removed, or, alternatively, a sense of the extent to which financial reform will proceed. Members of Congress can expect a lot of pressure from major players who need a more definitive basis on which to plan for the next five to ten years.

The second reason for expecting genuine reform is that the regulatory framework itself is visibly in disequilibrium. The structure dictated by the Glass-Steagall Act successfully prevented ~~prevented~~ banks from doing new things for several decades. Recently, that old regulatory structure seems to be disintegrating before our very eyes. The Office of the Comptroller of the Currency has made a preemptive strike at reform, suggesting that it may offer national banks substantially greater freedom to enter nonbanking lines of business through bank subsidiaries. If this effort prevails, the always-delicate balance between the attractions of national and state charters will be tipped decisively. For state charters to regain franchise value, substantial further steps will need to be taken to loosen regulatory constraints on state-

chartered banks, their branches, and their holding companies.

A third reason to think we are likely to see Congress actively reform the regulatory structure of the financial sector is the deposit insurance premium issue, which in the short run is building even more insistent pressure for change than the Comptroller's initiatives. The bank insurance fund, BIF, and the savings association insurance fund, SAIF, both charge the same premium. BIF premiums are slated to drop soon, because the insurance fund has been replenished after a severe drain a few years ago. SAIF premiums for thrift deposits, however, cannot be reduced for the foreseeable future, because the SAIF insurance fund has not been replenished, and because SAIF premium income also services the bonded indebtedness of FICO. The result is an impending 19-basis-point cost and price disadvantage for thrift deposits.

Already the BIF/SAIF issue is having predictable results. Even without active adverse selection, the expected cost differential would create a deposit leakage from thrift deposits to bank deposits. Moreover, the leakage promises to accelerate through adverse selection: SAIF members

that are in sound condition are applying for BIF-insured bank charters in order to channel deposits to the banks. As a result, SAIF will be subjected to a fundamental shock that, if left to play itself out, would leave the fund insuring the residual deposits of institutions unable to escape. SAIF premiums would decline, and FICO bond service would be in jeopardy. I don't intend to speculate about solutions to this insistent problem -- about whether the costs of avoiding the problem should be borne by taxpayers, depositors, or some other group. I simply point to this unresolved problem as an instance of a powerful disequilibrium in the financial markets today that will not be ignored. Instead, it promises to become part of the political horse-trading and congressional logrolling that will produce fundamental reform of the regulatory structure of financial markets in the United States.

Underlying all these pressures for change is a fourth, more fundamental force that has been at work from the very beginning. The 1930s' subdivided businesses and products into neat regulatory boxes and compartments. However, changing technology alone doomed this attempt to

compartmentalize the financial sector for purposes of permanent regulatory control. Especially as the computer and telecommunications revolution created boundless opportunities for innovation, including money market mutual funds and sweep accounts, the compartments became purely imaginary regulatory constructs, not natural divisions between timeless industries.

The end is not in sight. ATM network sharing and credit card companies have produced the nationwide -- approaching worldwide -- networks that only visionaries imagined possible 20 years ago. Cash cards, with transactions deducted from value registered in the card, now become more marketable if they can be refueled from the ATM network as well as other sources. Close to 30% of households have home computers of some description. It's not outlandish to expect that, within a few years, telecommunications networks like Internet will link a critical mass of households and almost all businesses. The opportunities this creates for innovations in commercial and financial markets cannot be predicted, but surely are enormous. Just as great, I believe, are the opportunities this

creates for crossing Glass-Steagall boundaries among regulatory compartments.

Conclusion

The regulatory structure of the 1930s is disintegrating, but financial reform involves both a rock and a hard place. The hard place is the inevitable jockeying of various interest groups to advance their respective competitive advantage. Each group claims to want its own version of reform, and that no reform would be preferable to the proposals favored by other groups. However, the rock that prevents movement past this hard place is how to limit access to the federal safety net. How can legislation remove the regulatory partitions without thereby removing the full measure of market discipline from activities newly associated with payment services. Can the federal agencies provide a credible assurance that they will not come to the rescue of firms which get into trouble in activities other than payments? Will reform be possible without taking the path of least resistance, the path of broadening access to the safety net? All I can say is, "Stay tuned."