FEDERAL RESERVE BANK
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MAJOR TRENDS IN THE U.S. FINANCIAL SYSTEM: IMPLICATIONS AND ISSUES

ROBERT T. PARR

PRESIDENT

FEDERAL RESERVE BANK OF SAN FRANCISCO

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I. INTRODUCTION AND OVERVIEW

Shaped by the interaction of economic, technological, legal, and regulatory forces, the U.S. financial system is undergoing significant change. During the next five to ten years, it increasingly will be characterized by:

- reliance on primary securities markets, with a diminishing role for traditional bank-provided intermediation;

- institutional realignment of functions in the provision of financial services, including clearing and settlement;

- expanded access to the payments system; and

- geographic integration, including internationalization of financial activity, with around-the-clock trading and settlement.

The present legal and regulatory structure often conflicts with the fundamental economic and technological forces. Moreover, efforts to resolve these conflicts and accommodate market forces are piecemeal, resulting in several undesirable consequences. First, financial change is occurring through the exploitation of loopholes rather than in a manner that ensures the evolution of an efficient financial system. Second, partial integration of financial activities and of financial and commercial activities is occurring without resolving the important issues of how to reform the federal safety net and how far to extend its coverage. And third, as activity shifts to international financial centers and less-regulated nonbank firms, domestic banking firms are involved in a diminishing proportion of overall financial activity.

The legal and regulatory framework should be reformed so as to accommodate market-driven forces for change. However, such reform also must be consistent with the goal of preserving financial stability. I believe that this requires at least limited government insurance of payments and savings balances held by depositories. However, we also are concerned that government protection be structured to minimize the perverse incentives for risk-taking and the possibility of large government expenditures that this type of intervention can create.

My remarks today are directed toward a conceptual framework for both understanding the changes occurring in the financial system and analyzing the policy implications of those changes.

A strongly held premise in my remarks is that, to the extent possible, we should allow market forces to determine the future course of the financial system. We cannot do so, however, without considering reforms in the design and implementation of the federal safety net and in the payments system. Issues involving deposit insurance and the safety net necessarily are central to any discussion of expanded bank powers. Likewise, as payments volumes increase and nondepository institutions gain indirect (and perhaps even direct) access to the payments system, issues of how the Federal Reserve's direct participation in the payments system is administered and how the system is regulated or supervised become more pressing. For these reasons, I will focus my remarks on the federal safety net, bank powers, and the payments system.

II. EMERGING TRENDS

Before I proceed to the issues, let me touch very briefly on each of the four key trends noted above:

1. *Direct placement and securitization*

Increasingly, borrowers are placing debt securities directly with investors and relying correspondingly less on traditional financial intermediaries -- most notably, commercial banks -- as a source of funds. The trend for banks is to take on the role of broker, or even underwriter, to facilitate transactions in the primary market. Specifically, banks are selling financial guarantees, like standby letters of credit, in support of primary transactions, and selling or "securitizing" loans that they originate and service (that is, pooling loans and using them as security for marketable debt instruments that are sold to primary investors).

This rise in direct placement and securitization is the result of a number of underlying economic forces, such as the declining cost of processing and transmitting information and the volatility of interest rates, exchange rates, and asset prices in recent years. These factors have spurred the growth of secondary markets, and futures and options markets, which permit investors to tailor their desired mix of liquidity, credit, and interest-rate risks. Moreover, regulatory restrictions such as reserve requirements and tighter capital regulation of banks reinforce the economic incentives favoring direct placement and securitization. However, banks will not cease entirely to intermediate -- they will still hold loans to borrowers whose creditworthiness is costly for the market to evaluate or whose funding needs are nonstandard.

2. *Functional realignment*

Economic forces such as the demand for greater convenience in financial services, the declining cost of effecting transactions, and the growth of securitization and direct placement are causing a breakdown in institutional specialization. Commercial banks, thrift institutions, securities firms, insurance companies, and other types of financial and nonfinancial companies increasingly are offering products that overlap with one another's traditional markets. Although these developments do not necessarily portend full-scale integration of financial service firms, they do suggest that the old institutional boundaries governing firms' activities are breaking down and a realignment of the types of services each firm chooses to provide is taking place.

3. *Expanding access to the payments system*

Many of the forces that are encouraging realignment in the provision of financial services also are behind nonbanks' desire for access to the payments system. In particular, the increasing integration of payments and securities activities brought about by the trend towards direct placement and increasing sophistication in cash management is making direct access to the payments system more valuable than in the past. Coupled with these economic forces are regulatory constraints like requirements for non-interest-earning reserves and the prohibition against explicit interest on demand deposits, which encourage the use of alternatives to bank-provided payments balances. Nonbank firms are responding to these incentives through the establishment of such bank-like subsidiaries as thrifts and nonbank banks.

4. *Geographic integration*

The growth of international trade and commerce, the integration of financial markets and payments media, and the declining cost of information technology appear to be increasing the optimal geographic scope of firms in banking and finance. As a result, there is a trend towards the internationalization of capital markets and the interstate provision of domestic financial services.

III. IMPLICATIONS AND ISSUES

These trends in the financial system raise a number of public policy concerns. First, the present approach to regulation of the financial system encourages an inefficient use of resources. For example, resources are devoted to discovering and exploiting loopholes in the current legal and regulatory system. More importantly, the result of this process is a structurally inefficient financial industry that is characterized by a proliferation of new instruments, transfer of traditional banking activity to nonbanks, and payments volumes that are excessive in relation to economic activity.

Second, without deposit insurance reform, the expansion of bank powers and/or the integration of financial and commercial activities may lead to an undesirable propagation of the deposit insurance subsidy. For example, a stressed nonbank affiliate might draw financial support from the bank, endanger the bank, and indirectly be supported by the deposit insurance fund.

Third, the growth of international financial centers and of unregulated firms' involvement in the provision of financial services implies diminished federal supervisory leverage over financial activity that may be essential to financial stability. Diminished supervisory control is particularly troublesome in light of concern about the potential for undesired or unintended *de facto* extension of the federal safety net.

The current legal, regulatory, deposit insurance, and payments frameworks are inadequate to address these policy concerns. In particular, reform of deposit insurance, permissible bank powers, and the payments system is needed to preserve financial stability and to accommodate a changing financial environment.

Reform must be based on a clear understanding of what needs to be protected and how extensive that protection ought to be. Although there is no simple answer to this question, both the payment and credit intermediation functions of depositories probably need at least partial protection. The extent of that protection, however, depends on a careful balancing of the costs and benefits of additional government-provided protection and on a reappraisal of the systems by which we insure, regulate, and close institutions.

Deposit Insurance and the Federal Safety Net

Recently, a record number of bank failures, the large foreign-debt exposures of the money-center banks, and the well-publicized problems of the FSLIC have brought into question the viability of the deposit insurance system. It is now widely recognized that the current deposit insurance system introduces a moral hazard: insured institutions have an incentive to take on excessive risk. The combination of flat-rate premia unrelated to risk; coverage of all deposit, and perhaps even nondeposit, liabilities (at least at large banks); and a willingness to let insolvent banks and thrifts continue to operate, has seriously diminished the market's discipline of risk-taking.

These policies place a heavy burden on regulation and supervision as the main forces limiting risk-taking. As the banking and financial system evolves, the implied protection of deposit insurance could propagate widely, placing an increasingly heavy burden on supervision and regulation, and leaving the government to underwrite risks for larger and larger segments of the economy. Thus, reform of the deposit insurance system is central to and a prerequisite for financial reform.

There have been many proposals for reforming the deposit insurance system. Some involve restricting the scope of deposit insurance coverage while others seek to "reprice" insurance so as to reduce the moral hazard problem. I will provide a broad overview of the pros and cons of these approaches.

Reducing the Scope of Deposit Insurance

Perhaps one of the oldest reform proposals dates back to Henry Simon's 1948 proposal for 100-percent reserve banking. This idea, which, in essence, has been revived by Robert Litan and John Kareken among others, would turn banks into institutions similar to money market mutual funds -- that is, banks' liabilities would be used to fund only safe assets, such as short-term government securities, cash, and reserve balances at the Federal Reserve.

If banks were required to back their liabilities with only "perfectly safe" assets, they would not fail. Moreover, no restrictions on the ownership of such "eunuch" banks would be necessary since there would be no opportunity for the bank to support failing nonbank affiliates. (The bank's deposit liabilities would be used to fund only safe assets and not to fund any form of credit, including intraday payments credit, to affiliates.)

Implicit in this approach is the notion that we need to protect only the payments system or payments-related balances. (In fact, in the extreme situation just mentioned, we would not even need deposit insurance.) Under such a proposal, however, meaningful credit intermediation would take place only in uninsured financial institutions that would be similar to current-day banks in most respects except that they would not be allowed to offer insured transactions accounts. These uninsured intermediaries probably would use short-term liabilities to fund risky loans to some degree, and thus could be subject to uninsured depositor runs. Thus, although this proposal might provide adequate protection for the payments function of depositories, it would offer no protection for credit intermediation, and therefore, insufficient protection of the financial system.

Another proposal focuses on explicitly restricting the payouts made to depositors so that they would provide some surveillance of depositories' risk-taking. Traditionally, this has been done by fully insuring each deposit only up to some maximum amount. The main drawback of this approach is that it would provide no protection against runs by uninsured depositors. To the extent that one believes that such depositor runs are potentially destabilizing to the financial system, as apparently was the view of regulators in the Continental episode, proposals of this nature offer insufficent protection.

Repricing Deposit Insurance

A second approach is to maintain fairly broad insurance coverage of the payments and credit functions of financial intermediaries while "repricing" that coverage so as to reduce the moral hazard. The most obvious way to do this would be to charge an insurance premium that rises with the *ex ante* risk assessment of the insured institution's portfolio. This is sound conceptually because it would penalize bank equity-holders for excessive risk-taking and thus would internalize the costs of risk-taking along with the benefits. In practice, however, this proposal could prove extremely difficult to implement because it would require charging a (potentially burdensome) insurance premium based on examiners' subjective assessments of the *ex ante* market values and risks of a bank's portfolio of assets.

A more promising method of internalizing risk is to require that insured institutions be closed before the market value of their equity could fall below zero. Since a closed institution's assets necessarily would be sufficient to discharge its liabilities at the time of liquidation, failed (i.e., closed) institutions would not impose losses on the insurance fund. Instead, bank equity holders would bear the full costs and benefits of their decisions and would have no incentive to take excessive risks.

Moreover, as long as depositors were confident that regulators would be successful in closing banks before the market value of equity became negative, depositors would not run on a "troubled" bank since they would be protected from losses through prompt closure of the bank. In this manner, it would be conceptually possible to protect deposits and prevent runs while simultaneously confining risk to bank equity holders.

To be effective, however, this approach would require increased and more frequent federal supervision of insured institutions to monitor closely the market values of their equity. The major practical difficulty would be in assigning accurate market values to non-traded assets, liabilities, and activities.

Any practical implementation of this approach would have to allow for errors in closure due to inaccurate assessments of market values of equity. If depositors believed a bank might be closed too late after equity turned negative, for example, they would run unless they could be assured that losses would be covered by a third party such as the deposit insurance fund and/or perpetual bank debt that is subordinated to deposits.

An alternative way of allowing for errors in assessing market values would be to give regulators the authority to err on the safe side by requiring a bank with risky assets or a low market value of equity to increase equity -- and closing the bank if it could not or would not do so. (The current risk-based capital proposal, which would require banks with more risky assets and off-balance sheet activities to hold more capital, is a step in this direction, although its focus on market valuation is very limited.)

The implementation of a prompt market-value closure rule would raise many political problems, especially during a transitional period. For example, the closure of institutions that are currently insolvent would raise major problems for the FSLIC, and possibly even the FDIC. However, it is these very institutions that now pose the gravest threat to the insurance funds. Nevertheless, I believe that it is possible to move closer to market-value accounting and closure rules, and that the consequences of such rules on *ex ante* risk taking would be highly desirable.

Bank Powers

The current restrictions on bank ownership and powers, enumerated in the Glass-Steagall and Bank Holding Company Acts, stand in the way of the trend towards functional realignment in the provision of financial services. While market forces will foster the development of alternatives to bank-provided payments and credit-services, these alternatives may not be the most efficient from society's perspective.

Specifically, preservation of the current restrictions on bank powers will cause financial activity to continue to shift away from banks to nonbank banks, thrifts, and investment banks. This implies both a relative decline in business transacted by banking firms and a rearrangement of activity within the corporate structure of bank holding companies. Failure to resolve the nonbank-bank issue may even cause banking firms to shift traditional banking activities to nonbank subsidiaries. Financial activity also will continue to shift to less-regulated international centers, and bank regulators will find themselves regulating and supervising a shrinking share of total financial activity.

Resolution of the bank powers issue requires a careful balancing of seemingly contradictory concerns. On the one hand, if federal oversight of financial activity is essential to stability, then regulation must not be so onerous as to cause that activity to seek unregulated outlets. On the other hand, some minimum level of regulation, or at least supervision, is necessary to prevent excessive risk-taking by firms that benefit from the protection of the federal safety net.

As we consider the extent to which bank powers ought to be expanded in response to market pressures, it may be useful to reconsider the original rationale for separating banking from other financial services and from commerce. Of primary concern to legislators in the 1930s were the problems associated with concentration of resources and the potential for self-dealing. Such problems have been addressed, with varying degrees of success, in other countries without completely separating banking and securities markets. Moreover, in the U.S., these concerns may be mitigated to some extent by the existence of SEC regulations and surveillance, which did not exist prior to the 1930s.

Unlike the 1930s, a key concern regarding bank powers today is the possibility that expanded powers would enable banking organizations to extend the benefits of the federal safety net to additional activities. For this reason, some have argued against expanding the powers of banking organizations, while others have argued that new powers should be granted so long as they are carried out in separate subsidiaries. Most observers agree, however, that the type of corporate separateness that we have today is not very likely to insulate the bank from losses of a nonbank affiliate in times of stress.

Instead, reform of the deposit insurance system to reduce its risk-taking incentives is needed as bank powers are expanded in response to market forces. Along with a program for meaningful insurance reform, two broad reforms of bank powers might be considered.

First, we might consider accelerating our efforts to expand the financial powers of banks. In other words, banks might be allowed to underwrite and trade securities, underwrite and sell insurance, manage mutual funds, and offer other financially-related services. This approach would accommodate the trend towards functional realignment in the provision of financial services. It also would enhance the efficiency of the financial system. A second general approach would be to expand both the financial and commercial powers of banks. This approach would enable banks to own and control commercial firms and *vice versa*. One advantage of such affiliations would be the reduction of risk through the conglomeration of dissimilar activities. However, the operating synergies between banking and commerce do not appear to be great.

In either case, broader integration of banking with other financial firms, or of banking with commerce, would raise problems in supervising the activities of diversified conglomerates and in enforcing corporate separateness, although there might be differences as to degree and complexity in each case. These problems have been addressed in other countries, particularly with respect to the integration of banking and investment banking, however.

The Payments System

The major trends I have enumerated also bear importantly on the payments system. There is legitimate concern that growing payments volumes and expanded access may increase both the possibility and consequences of losses arising from a payments system malfunction or from the failure of a major participant in the system.

In a payments system that utilizes the creation and extinction of credit to facilitate interconnected payments activity, such failures can generate liquidity problems for many participants. One of the functions of a central bank is to provide liquidity to sound institutions in such circumstances. However, central bank payments system policy should not imply protection against insolvency or even encourage frequent use of the emergency liquidity facility.

The current payments system is limited to depository institutions. Nonbank institutions are gaining access, however, through thrift and nonbank bank ownership. Such expanded access may not be desirable under current payments system conventions because it increases the difficulty of monitoring payments system risk and might increase the inefficient use of payments system credit, and along with it, the risk of payments difficulties. Thus, expanded access to the payments system should be viewed in the context of other policies to reform the payments system by reducing excessive reliance on intraday credit and delayed settlement.

Pricing Fed Credit

Excessive use of daylight overdrafts arises because intraday credit is underpriced in several respects. First, the Federal Reserve does not charge for the time value of daylight overdrafts. Second, the Federal Reserve does not charge for the default risk it assumes by offering finality of payment on Fedwire. Thus, receivers of funds on Fedwire are not a potential source of discipline in the payment-credit decision. Finally, because there may be risk of systemic failure on private networks that is not taken into account by the individual participants, payments credit on these networks also may be "underpriced" and over-used from a social perspective.

Pricing of intraday Federal Reserve credit would remove a major stimulus to the overuse of intraday credit, both on Fedwire and on private wholesale networks.

Ideally, pricing of intraday credit would embody not only the time value of funds, but also the value of the default risk implicitly assumed by the Federal Reserve on Fedwire. With a positive price for intraday credit on Fedwire, overall use of such credit would decline even on private networks.

Analogous to charging interest on Fedwire intraday overdrafts, interest should be paid on positive reserve balances held at the Federal Reserve. Symmetry in the treatment of borrowing from and lending to the Federal Reserve System would improve the functioning of the private intraday credit market and decrease Fedwire congestion associated with end-of-day transactions.

Pricing Fedwire intraday credit presumably would push more payments activity into the private credit market. Although funds receivers on private systems have an incentive to monitor and control their risk exposures, private bilateral payments decisions do not automatically take into account the total "social" credit risk involved. Reduction of this risk requires surveillance by the appropriate regulators and the principal participants in private payments networks.

Real-Time Settlement

The delayed settlement feature of present day private payments systems adds to the concerns raised by underpricing. Delayed settlement increases the chances that an adverse event will nullify the many transactions involved. Combined with excessive use of payments system credit, such an event raises the risk of coincident liquidity problems for participants and a possible general loss of confidence in the payments system. Intervention by the central bank to protect the economy from this eventuality is not costless and could create additional incentives for risk-taking, particularly if it extends beyond providing liquidity to ensuring solvency.

An increased price for intraday credit will encourage a transition toward "real-time settlement," whereby both monitoring of positions and matching of payments flows will occur on a continuous basis. A payments system should be a credit system (that is, one that bridges temporal gaps between the payment and receipt of funds through borrowing) only if it is more efficient than expending resources either to make transactions synchronous or to maintain excess balances of good funds. Under the current system, borrowing and asynchronous payments are favored. With costly intraday credit, participants will seek the means to synchronize transactions and settle obligations in "real time." For example, repayment of funds borrowed overnight will be more closely matched in time with funds inflows that reflect borrowing for the next night.

Since real-time settlement eliminates, by definition, temporal risk in the payments system, evolution toward real-time settlement will contribute significantly to reducing payments system risk. As around-the-clock and global securities trading progresses, the importance of managing temporal risk will mount and real-time payments technology increasingly will be necessary to manage risk economically.

IV. CONCLUSIONS

The major trends in the financial system are driven both by fundamental economic forces and by attempts to circumvent regulation and exploit government guarantees. While most would admit that a thorough reform of financial regulatory and legal policy is long overdue, resolving the debate over just what changes are necessary apparently has paralyzed the policy-making process. Although there are no easy or simple solutions, three areas are especially in need of thorough reform: the federal safety net, bank powers, and the payments system.

While banks are experiencing economic pressures to expand into nontraditional activities, a major reason for preventing them from doing so is to limit the scope of deposit insurance coverage. However, many observers question whether the U.S. banking industry will be able to compete effectively if it continues to be regulated more stringently than domestic nonbank firms and banking firms in other countries. It would be preferable to reform our deposit insurance system so that banking powers can evolve in a market-oriented environment.

Similarly, the implicit government guarantee behind the payments system may prove to be unsustainable in the face of rapid financial innovation. Underpriced intraday credit in conjunction with delayed settlement appears to be a major part of the problem. Without reforms in these areas, expanded payments system access poses further risks.

There are many approaches to financial reform, some of which are touched on here. The most desirable replicate the advantages of market mechanisms as much as possible.