

SYSTEM MANAGEMENT CONFERENCE

COMMENTS BY THOMAS C. MELZER

"MAJOR TRENDS IN THE U.S. FINANCIAL SYSTEM:
IMPLICATIONS AND ISSUES"

BY ROBERT T. PARRY

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President Parry's paper views the expansion of bank powers as inevitable: technological, economic, and regulatory forces have increased competition among financial and non-financial institutions and lowered the profitability of traditional banking services. Thus, if banks are to survive, they must increase the range of services that they can offer. Yet an increase in bank powers would increase risks and might undermine the confidence which is a necessary condition for the stability of a fractional reserve banking system.

I presume that this conference will attempt to find some optimal combination of maximum powers and minimum risk, but before we delve into these murky waters, I would like to back away from current trends and the inevitability of events and ask some fundamental questions which may help to focus our subsequent discussion. In doing so, I will make two non-heroic assumptions: that we will not consider a 100 percent reserve banking system, and that true "corporate separability" is a myth.

The first question is why a central bank should get involved in this regulatory dilemma? It seems to me that there are two compelling reasons. One is that the central bank as a regulator of the quantity of money is concerned with institutions that create money. Since this money creation is predicated on public's confidence, this confidence must be maintained and fostered. A collapse in confidence may mean a contraction in liquidity with disastrous results for the economy as a whole.

The second reason is that the central bank is entrusted by law, tradition and circumstances to maintain an efficient payments mechanism. The payments system is a resource which significantly contributes to the functioning of the whole economy. Its efficiency again depends on confidence that transactions will be settled and that potential losses would be held to a minimum. With increased access to the payments mechanism, risks increase and confidence may become impaired. Thus, the interest of the central bank in these two functions lies in their ability to potentially disrupt the functioning of the whole economy.

The second question is how has this maintenance of confidence has been fostered in the past? Apart from the central bank being a lender of last resort, and the existence of various insurance schemes, a traditional method of reducing the risks of banks was to prohibit them from holding non-financial assets which are subject to price level and relative price risk. Thus, ownership of real assets or direct claims on real assets (equities) was not allowed, and ownership of banks was restricted to institutions which did not hold real assets. Access to the payments mechanism was limited to banks, thus reducing the potential of substantial failure.

Because I feel that our concern should be with regulation that protects our functions as regulator of money creation and guardian of the payments mechanism, I prefer to take a narrow view of bank powers and bank regulation.

My concern with expansion of bank powers as a substitute for earnings from intermediation lies mainly in the fact that such expansion will necessarily create additional risks which may undermine the basic

goals and purposes of a central bank. We should assume those risks only if we have good reasons to do so as a central bank, not because current trends are moving in that direction. In addition, a broader scope of bank powers will inevitably lead us to desire regulation of more financial and nonfinancial institutions with the attendant political criticism and battles for "turf." Such politicization of a central bank may bring about the end of all the vestiges of our independence and perversion of those functions which are basic for a central bank.

Our regulatory constituency, given our central bank functions, should be those institutions that have liabilities that are payable on demand to a third party, and the ownership of banks should be limited to similar institutions. The access to the payments mechanism should be restricted to banks. Such a restriction would counter the shrinking revenues from intermediation by increasing revenues from banking operations--access to the payments mechanism. And the regulation of a very specific group of institutions, rather than a broad range of economic entities, would be simpler, more effective and enhance the safety of the payments system.

I would propose, then, to:

1. redefine as a bank any firm that has liabilities payable on demand to a third party through check or wire transfer;
2. limit the powers of banks (as defined above) and bank holding companies to those they now enjoy;
3. support risk-based capital requirements or risk-based premiums on deposit insurance to limit incentives of banks to assume excessive risks.

I realize that this may be viewed as a "reactionary" approach, but it solves many of the problems raised in Bob Parry's paper with one simple, and politically justifiable, redefinition of a bank. It also does not jeopardize the economic survival of the banking system or compromise our position as a central bank. By the same token it increases our ability to control risks and enhance confidence--the cornerstone of fractional reserve banking and an efficient payments mechanism.