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DOES GOVERNMENT REGULATION WORK?

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Regulation of business by government is not new. The Emperor Hammurabi established a central government in Babylon around 2000 BC and promulgated a code of over 300 laws. Some dealt with business activity and seemed to be aimed at assuring integrity in business dealings.

Some 15 centuries later, Aristotle wrote the following: "He who purposes duly to manage any branch of economy should be well acquainted with the locality in which he undertakes to labor and should be naturally clever, and by choice industrious and just; for if any one of these qualities be wanting, he will make many mistakes in the business which he intends to take in hand."

Aristotle was talking about management of business, not its regulation by government. Today, however, much business decision-making and policy-setting are preempted by specific government regulation or by a regulatory agency. Are the qualities Aristotle required in a business manager present in today's regulatory bureaucracy?

One way or another, most of American business is regulated by federal, state, and local government. Some industries are more closely regulated than others: the railroads, truckers, and public utilities, for example. They have territories, rates, quality of service, and even accounting systems prescribed for them. Financial institutions are also closely regulated by federal and state authorities, and it is the effectiveness of that regulation which is to be questioned here. Does government regulation of financial institutions work?

There is plenty of evidence that government regulation of financial institutions does not work. There is even more public opinion to that effect. A skeptic might even suggest that in those circumstances where regulation does seem to work, other factors are really responsible.

The present regulatory system was shaped by conditions which were generally negative and which the public and the institutions themselves wanted to avoid repeating. Of all the calamities, the Great Depression was probably the most profound.

Notwithstanding this negative genesis, most regulators of financial institutions see their role as one of making positive contributions to our society and our economy. Naturally, there are obvious conflicting interests. Businessmen, homeowners, and trustees of deposit insurance funds would measure success differently. How regulators deal with these interests is one way of gauging their success.

The Regulatory Tightrope

The Home Owners Loan Act of 1933 and the National Housing Act of 1934 were drawn to provide emergency relief to homeowners then suffering from the Depression and to encourage future thrift and home ownership. The federal savings and loan system, Federal Home Loan Bank System, and Federal Savings and Loan Insurance Corporation (FSLIC) were created to help meet these objectives. Federal insurance of bank deposits came into being also.

Perhaps the greatest conflict among regulators of financial institutions is that which exists between the providers of capital and the users of capital. Other conflicts exist within the classes of capital providers and within the classes of capital users. Lately there have also arisen conflicts between regulatory agencies. For example, the SEC and federal bank regulators disagree over how full "full" disclosure should be for publicly owned banks. The SEC wants bank stockholders to be fully informed, while bank regulators are fearful that bad news might cause the depositors to lose confidence and bolt.

How do the regulators deal with conflicts and decide which policy will best serve the "public interest"? The savings and loan industry represents a simple example of providers (mainly individual savers) who had put up $286 billion at year end 1975. How does the Federal Home Loan Bank Board balance thrift, economical home ownership, and the interests of the FSLIC?

A federally chartered savings and loan organization is required to make most of its home loans to people of modest means. Regulations also prescribe the maximum loan to value ratios and require that most loans be made on properties within a prescribed distance of their office. Such limitations are intended to reduce the investment risk, and thus protect the savers' interests and the FSLIC.

But what happens when people of less than modest means expect or are perceived by politicians as deserving to become homeowners? Many of these families cannot come up with a 20 percent down payment on even a $30,000 home. When that home inflates in value 10 percent or more annually, the prospective homeowner is further behind.

The government's response has been to subsidize both the risk and the direct cost of housing. The problem is that a few of these arrangements are in the form of hidden subsidies that offer a potential for regulatory abuse. For example, the FHLBB is under no legal or self-imposed

requirement when it decides what net worth must be maintained to protect savers and the FSLIC. (Perhaps even weaker statutes exist for the banking industry.) Nor is the General Accounting Office, to the writer's knowledge, required to examine the propriety of the FHLBB's net worth requirements or the FHLBB's administration of its rules. Thus, there is an accountability gap, and capital providers can unknowingly lose their net worth protection.

The "redlining" issue, so much in the news lately, is another example of a conflict between providers and users of capital. On the one side, inner city borrowers complain that lenders (mostly S&Ls since they finance the majority of single-family homes) refuse to lend in their neighborhoods. A red line is drawn, in effect, on a map delineating the area in which loans are not made. Usually these areas are racially changing, which raises the specter of discrimination, too.

However, regulatory agencies are not at all certain that lending money in areas which appear inevitably headed for urban decline is in the interests of the lending institutions, its savers, or the FSLIC. Ironically, independent studies of urban decline show that disappearance of financing is one of the last factors in the process. In other words, withholding mortgage credit because of perceived urban decline is not a self-fulfilling prophecy.

It is hard to fault the intent of legislators and regulators when it comes to opposition to redlining. It is highly doubtful, though, that their response—requiring the disclosure of lending patterns—will open up a flow of housing credit to the inner city. Prior attempts at credit allocation in the form of government-supported housing projects clearly have not worked well.

The Regulation Q Debate

Regulation Q presents another clear conflict between the providers and users of capital in the S&L and banking industries. Regulation Q, which controls interest rates that may be paid by banks and S&Ls, was first adopted to prevent banks from waging interest rate wars.

When savings and loan associations were brought under a rate control statute in 1966, it was for somewhat the same reasons as for banks 30 odd years earlier, except there was no general depression. There was concern, instead, that too much money was being taken out of the East and invested in the West Coast S&Ls. These S&Ls, mainly in California, were thought to have fully exploited the market for sound loans and there was concern that a further rapid savings growth would lead to serious loan portfolio problems.

The regulatory authority clearly is acting in the interest of savers when it acts to curtail unsound growth. But it is not entirely clear that instituting rate control on consumer savings has had that effect. Many S&Ls in California and Nevada were de facto failures, anyway, as a result of growth which took place prior to 1966. Some of these failures were not dealt with decisively until the 1970s; and to top it off, rate control on S&Ls was legislated in the first year of "disintermediation," precisely when many S&Ls could have benefitted from freedom to compete on a price basis. Interestingly, some of the political pressure to subject S&Ls to rate control came from the banking industry, which was becoming conscious of the consumer savings market.

Now, 10 years later, Regulation Q is the law of the land. On passbook savings, banks cannot pay over five percent, while S&Ls can pay 5¼ percent. Similar differentials exist for longer term accounts.

A checking account was considered a privilege reserved for those who had money, and an account in our bank implied a certain standing. A new account was not opened unless the prospective depositor had a proper introduction. . . . A bank check was not then the common medium of exchange that it is now, and a depositor who insisted on drawing a great number of checks for small amounts would be reprimanded by the cashier.

—AN "OLD TIME BANKER"

Is the saver's ox being gored by Regulation Q? That depends on whether one deals with a large or small saver, with a sophisticated or unsophisticated saver. The small saver has no choice. He cannot beat Regulation Q by going into Treasury bills at 7.5 percent or better because the price of admission is too high. So the little guy is stuck with 5 percent at a bank or 5¼ percent at an S&L.

But what about savers in federally insured financial institutions as a group? Are they being allowed to earn a fair return? Aside from the stated objective of protecting S&Ls as providers of housing finance, it is really difficult to rationalize a lower return for savers in banks compared to savers in S&Ls. Who are the beneficiaries of this price-setting? Specifically, the beneficiaries are homeowners who were either clever or fortunate enough to borrow on a fixed rate prior to 1973. These users of capital enjoy interest rates of about 6 to 8 percent and are being subsidized, in effect, by borrowers at 9 to 10 percent and/or savers as a group.

The regulatory response to this inflation-induced dilemma has not been particularly effective, or perhaps even appropriate. Variable rate mortgages have been proposed by the FHLBB but shot down by Congress. Mortgage repayment terms have been stretched to the limit, arguably even to the disadvantage of the borrower, who has traded a 30-year loan for a 40-year loan, with weekly reductions in loan payments equivalent to a six-pack of beer. At the same time, the FHLBB has looked the other way as profitability of S&Ls continued to be on the low side, with an accompanying slippage in net worth ratios.

The Insurers' Dilemma

FDIC and FSLIC insure deposits of up to $40,000. At year-end 1975, banks had total domestic deposits of almost $900 billion, and S&Ls had total deposits of $286 billion. FDIC had reserves for losses of about $6 billion and FSLIC had reserves for losses of about $4 billion. Both agencies have statutory lines of credit with the US Treasury. (It is of interest that all these assets have been borrowed by the US government and used for purposes not easily determinable.)

Both agencies have been put to some fairly tough tests and survived. FSLIC has made payoffs to savers that exceeded $100 million after one failure. It has also used its default prevention powers for institutions ranging in size up to $1 billion. While FDIC has not suffered payoff experiences of the magnitude of FSLIC, it has faced the collapse of banks ranging up to $5 billion in assets.

Given the deposit insurers' large exposure and relatively small resources, is there a proper balance of concern on the part of the regulators between the need for risk taking and the need to keep FDIC and FSLIC losses at tolerable levels? Or is there a bias built into the system which tends to deny financial institutions the "right to fail"? This issue is different between the banking industry and the S&L industry, because on the S&L side, the principal regulator of behavior is also the overseer of the FSLIC. FDIC, on the other hand, is not the principal regulator for many insured banks and must take its cue from other federal or state agencies. The result is some degree of corporate schizophrenia. Are FSLIC and FDIC to be pure insurance functions, or are they to also perform other roles, such as muscling financial institutions into behaving in certain ways without regard to the insurance risk involved?

There is no legislation—I care not what it is—tariff, railroad, corporation, or of a general political character, that at all equals in importance the putting of our banking and currency systems on the sound basis proposed in the National Money Commission [Aldrich] plan.

—WILLIAM HOWARD TAFT, 1911

The business of federal regulation is replete with examples of massive overkill, mostly in the name of consumer protection. Blame for this certainly does not lie exclusively with the regulatory agencies, but a major share does belong to the federal regulators. When Congress perceives mistreatment of consumers, it confers more power and responsibility on the regulators. An example:

Regulation Z (by no means the last) is a Congressional enactment which is intended to protect borrowers from being misled on the real cost of credit. The popular title of this legislation is "Truth in Lending." From that, one might conclude that there was a significant public harm done by lenders who lied or misrepresented or did not fully or properly disclose what credit actually cost. No doubt there have been incidents of consumer abuse. But it is probably also true that those who are hurt by excessively costly credit or unfair credit arrangements will not benefit by knowing the "true annual percentage rate" on a loan. (I am thinking of the victim who gives back $20 to the loan shark on Friday for the $10 he borrowed on Monday.)

There is an ironic twist in all this government protection of the consumer. Before Congress intervened, the overwhelming majority of Americans had for many years benefitted from the finest, low-cost consumer credit system in the world. Hopefully, this will continue in spite of Congress' well-meaning but misguided efforts.

Not too incidentally, the regulatory bureaucracies were relatively silent in testifying to the true need for Regulation Z. That is consistent with the nature of the bureaucratic process, which is generally not to turn down an opportunity for growth.

The regulators are being told by Congress to train their elephant guns on different gnats almost every day. The Equal Credit Opportunity Act, the Fair Housing Act, the Bank Protection Act, the Fair Credit Reporting Act, the Bank Holding Company Act, the Savings and Loan Holding Company Act, the Financial Institutions Supervisory Act, and a series of "Emergency Housing" acts are all on the books. Other legislative proposals have been trial ballooned, such as the Financial Institutions Act of 1975 and the 1976 follow-on Financial Reform Act. The latter even went so far as to propose a reform of sorts for the financial regulatory agencies.

The Prognosis for Regulation

It is probably going to get worse, worse being defined as more. Unfortunately, government regulations tend to multiply like bacteria in a nutrient-rich culture. The regulated industries in the case of regulators are the culture and, up to now, have been able to support a sustained growth of the regulators. As a result, however, financial institutions' profitability, especially for the thrifts, has not been adequate on balance since 1962. (Not that declining profitability is likely to deter growth. One recalls C. Northcote Parkinson observing the growth of the British Admiralty during a period when commissioned capital ships decreased by almost 68 percent; meanwhile, the Admiralty grew in number of officials by over 78 percent.)

As a nation, we are rushing pell-mell into regulation by government of practically all our activities. At the same time, there is a growing feeling that our government is less and less representative of the people. The confluence of inordinate control by a nonrepresentative government should be a frightening prospect. Yet most people seem to believe that business needs to be more highly regulated. Even businessmen seem to embrace the status quo. Suggest a lessening of regulation—like putting Regulation Q on a 5½-year phaseout—and most of the S&L industry and even some banks become very concerned.

Regulatory reform is a difficult, political issue. Given the entrenched special interests of the regulatory agencies' staffs and the transient, short-time political appointee status of agency chairmen and board members, it is probably impossible to reform the system short of a major Congressional effort. Meanwhile specific modifications should be considered in the financial institutions area:

1. The regulatory powers of the agencies should be more stringently defined. Regulators should not be able to manage business conduct through financial institutions.

2. Prior to adopting consumerist legislation, there should be demonstrated significant abuse and an absence of existing law to deal with the problem, plus provision for an independent monitoring system to prove the efficiency of any legislative/regulatory solution. Congress should also require a cost/benefit analysis before any new regulatory empowerment.

3. Combine bank and S&L regulation, central bank systems, and deposit insurance systems in three agencies, one for each of the three basic functions.

4. If the combination cannot be effected, the regulatory system for the two industries should be organized on a parallel basis. This would be patterned after the bank regulatory system but with the insurance, central banking, and regulatory functions clearly separated.

5. The process for selecting political appointees to regulatory agencies should better reflect public interest.

6. Full disclosure of all information necessary to prudent decision-making should be the rule.

7. Premium rates for deposit insurance should partially reflect the underwriting risks involved.

Resistance to change is a common human trait. So it is with organizations. But there is danger in this response. For if the regulatory functions of government do not respond to changing needs and conditions, the pressure will mount for abrupt and radical change, perhaps even chaotic change. One need not look too far back in time to observe chaotic change. Compare these points of view:

"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."

"We should by one way or the other arrive at the bureaucratization of the economic activities of the nation."

Whose points of view were they? Adam Smith and Benito Mussolini, in that order. △

There is not in this country and there has never been in any country of the civilized world a government issue or banknote issue comparable in security to the Federal reserve notes provided by the bill which you are now asked to enact into law.

—CARTER GLASS, 1913