

Choices in Banking Policy

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It is a great pleasure to have the opportunity to meet all of you and to share with you some of my thoughts on issues related to banking—what I like to refer to as “banking policy” as distinct from monetary policy. When I first joined the Federal Reserve way back in 1970, I did research on banking issues, and in fact my doctoral thesis had to do with banking policy. As time passed I was drawn ever more heavily into the monetary policy area. But I have never lost interest in banking issues, and my new role at our Bank obviously gives me ample reason, to put it gently, once again to give this broad and challenging area a very high priority in my personal work schedule.

My remarks this afternoon will summarize some of the conclusions I’ve reached regarding major issues currently facing banks, bankers, and regulators. First, I will say a little about the efficiency of bank regulation as it exists today, how it should be evaluated, and how it might be improved. Second, I will look at some of the trade-offs between the regulatory burden we’d all like to reduce, on the one hand, and the scope of the federal safety net, on the other. Finally, I will comment briefly on consumer and community reinvestment issues, which are receiving especially intense attention presently.

I begin with the fundamental idea that financial system arrangements are generally most efficient if left to private choice. This is merely a corollary to the well-known presumption in favor of unfettered competition in unconstrained markets. The unique characteristics of banking and finance sometimes cause people to lose sight of the applicability of this principle to these industries, but the extraordinary recent innovations in banking and financial markets should convince skeptics of the power of a competitive financial system, given the chance, to seek and find the most cost-effective means of intermediating between borrowers and lenders.

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1. REGULATORY EFFICIENCY

Banking is one of the most heavily regulated of all industries. To determine the principles that ought to guide the design of banking regulation, we need first to ask why that regulation exists.

In my view, the strongest rationale for bank regulation derives from federal deposit insurance, discount window lending, and the Fed's involvement in the payments system. Together, these three activities are often referred to as the "federal safety net," but I find it most useful to think of them as credit enhancements provided by the federal government to the banking system. Deposit insurance is a third-party guaranty, analogous to standby letters of credit, private mortgage insurance, and other forms of credit insurance. Discount window lending is similar in many respects to a collateralized line of credit, and the credit extension inherent in the Fed's participation in the payments system is basically a clearinghouse overdraft facility.

Private providers of similar credit enhancements generally restrict the portfolio choice and risk-taking activities of recipients, since they recognize that third-party commitments often give rise to problems of "moral hazard"—to use a term coined in the insurance industry—which refers to the tendency of insured entities to take greater risks than they otherwise would. So, too, I think most people would agree that the government needs to constrain the portfolio choice and risk-taking activities of banks in order to protect the federal safety net from moral hazard.

A key point here, however, is that *competition among private credit enhancement providers forces them to minimize the burden of the restrictions they impose*. If one provider offers a guaranty with significantly more restrictive covenants than competitors offering the same guaranty, business is likely to be slow. On the other hand, a provider offering a guaranty with insufficient restrictions on borrower activity is likely to lose money steadily over time due to excessive risk taking by its customers. Competitive pressure ensures that constraints on the activities of recipients are *efficient* in the sense that they tend toward the minimum burden on borrowers consistent with actuarial soundness of the enhancement.

In my view, bank regulations should be efficient in exactly the same sense: that is, they should be just restrictive enough to protect the actuarial soundness of the federal safety net. Again, on the one side, insufficient restraint on bank activities could subsidize excessive bank risk taking and impose an unacceptable cost on taxpayers, the ultimate provider of federal credit enhancements. At the same time, however, excessive restraint on banking imposes needless costs on our financial system, increases the spread between borrowing costs and depositor returns, and ultimately risks reducing economic growth.

From this perspective, some aspects of current bank regulation clearly are flawed and in need of revision. For example, remaining restrictions on interstate

banking almost certainly could be eliminated without endangering the safety net. Indeed, a strong argument can be made that interstate banking would *reduce* risk to the safety net by allowing improved diversification of regional risks. Certainly, one of the fundamental banking lessons of the last decade ought to be the high risk of region-specific economic shocks to an industry that, for all of the structural changes that have occurred, is still dominated by local and regional institutions. It is regrettable that in the absence of federal legislation, we are forced to await a long and cumbersome process of statutory revision at the state level. Dismantling the existing barriers to interstate banking while preserving the competitiveness of banking at the local level ought to continue to be an important legislative priority.

Similarly, legislative restraints on bank entry into related financial markets are difficult to justify. The Glass-Steagall Act erects barriers between banking and commerce and between banking and securities markets. The barriers between banking and securities markets are said to be needed to prevent conflicts of interest, but our basic supervisory process seems quite capable of policing these—as it does now, for example, with trust departments—without the draconian prohibitions of Glass-Steagall. These barriers are often rationalized as risk-containment measures for the protection of the federal safety net, but, in the case of securities market activities, research has failed to support this claim. Fortunately, we have been able to ease some of these restraints at the regulatory level, but clearing away anachronistic federal statutory constraints in this area would make sense.

As I think you know, the Fed supports further relaxation of restrictions on interstate banking and bank powers, and these reforms, of course, were part of the Treasury Department's comprehensive proposals that led eventually to the Federal Deposit Insurance Corporation Improvement Act of 1991, or "FDICIA," as it is usually called. FDICIA was in large part a reaction by Congress to the perception that regulatory restrictions on bank risk taking were inadequate to protect the federal safety net. Regardless of whether that perception is fully justified or not, many of the Act's provisions, such as the requirement of prompt corrective action in the case of undercapitalized institutions, strike me as sound public policy and important steps forward. Other parts of the Act, however, failed to consider the costs of regulations that go well beyond what is required to protect the deposit insurance funds. Section 132 of the Act, in particular, which requires federal banking agencies to set so-called safety and soundness standards regarding operations, management, asset quality, earnings, stock values, and even employee compensation, seems clearly excessive. The actual language of this section is not much more specific than this, but it appears to envision rigid, predetermined rules for banks' internal management arrangements, irrespective of an individual bank's capital position. Such rules are not generally found in privately provided credit enhancements and, in my judgment, would constitute unnecessary, intrusive, and potentially

harmful micromanagement of any adequately capitalized bank. In short, Section 132 appears to raise the burden of bank regulation beyond the minimum level necessary to protect the federal safety net. The basic soundness of bank management has always been an important focus of the examination process. But it would be counterproductive to substitute mechanical formulas for the considered judgment of seasoned examiners, just as it would be undesirable to substitute mechanical credit approval rules for the considered judgment of seasoned loan officers.

With all of this in mind, let me just say that the Fed and the other federal bank regulators are striving to fulfill the intent of the law as efficiently as possible in implementing this section of the Act—in other words, with the smallest possible burden on the financial system. More generally—and somewhat ironically—another part of FDICIA, Section 221, directed the Federal Financial Institutions Examination Council (FFIEC) to review all banking regulations to determine whether they impose unnecessary burdens on regulated institutions and to make recommendations to reduce such burdens. The Fed and the other agencies that comprise the Council have completed this review and have already made a number of changes designed to reduce the burden of existing regulations. Beyond this, the Interagency Statement on Credit Availability issued in March, 1993, attempts to target exemptions from documentation requirements for better-capitalized institutions. This represents a step to build on in improving the efficiency of banking regulations by applying regulations more selectively to individual banks based on their capital.

All of these actions are constructive. It is important that regulations be refined on a continuing basis to improve their efficiency. There are limits, however, to the improvements that can be made in the context of the current statutory environment. In this regard, Federal Reserve Governor LaWare's suggestion—that an independent, nonpolitical commission be created and charged with developing a legislative agenda that would deal with regulatory burden in the broader context of the changing competitive condition of the banking industry—seems to merit greater attention than it has received to date. Some of you, recalling the legislative process that produced FDICIA, may reasonably wonder whether a broad banking reform effort can ever succeed. I don't have an easy answer to that question, but I do believe that the effort should be made and that an independent commission is a useful suggestion.

2. THE TRADE-OFF BETWEEN REGULATORY BURDEN AND THE SCOPE OF THE SAFETY NET

While we must constantly strive for the least costly and most efficient regulations to support the *existing* safety net, we also face broader choices in banking policy. Even if we were to achieve the least burdensome regulations consistent

with the actuarial soundness of the safety net as it exists today, as a society, we might still conclude that the costs exceed the benefits the safety net provides. Further reductions in bank regulations could then be sought by reducing the governmental credit enhancements the regulations are designed to protect—that is, by reducing the extent of the federal safety net. Private providers of credit enhancements typically allow less restrictive constraints for less extensive guaranties. For example, less onerous loan covenants are required of a borrower with lower leverage. Similarly, if the federal safety net were scaled back, we could reduce the regulatory burden on banks.

Two related and frequently overlooked provisions of FDICIA take important steps in this direction. First, FDICIA requires the FDIC to select the least-cost method of resolving failed depository institutions and to document its decision. This is important because least-cost failure resolution can reduce the extent to which uninsured depositors are implicitly insured at a higher cost to the insurance funds—in other words, it can limit the *implicit* scope of deposit insurance and the safety net. Second, FDICIA contains provisions designed to discourage Federal Reserve discount window lending to critically undercapitalized institutions and in some circumstances it imposes losses on the Fed in the event a borrower fails. These provisions seek to prevent discount window loans from artificially prolonging an institution's life and allowing uninsured claimants to continue withdrawing their funds at the expense of the FDIC. While these provisions have yet to be tested by the actual failure of a large institution, they should work to limit the scope of the “too-big-to-fail” doctrine and heighten the monitoring incentives of uninsured claimants, which would strengthen the case for easing bank regulation, especially the Section 132 variety.

In my opinion, perhaps the most disappointing aspect of FDICIA was the omission of any significant reduction in explicit deposit insurance coverage. A strong argument can be made that even apart from “too-big-to-fail,” the coverage of federal deposit insurance is excessive from the standpoint of the incentives it creates (and doesn't create) among bank managers and bank customers and the risk it presents to the deposit insurance fund and ultimately the taxpayer. Reducing the extent of explicit deposit insurance coverage would provide a compelling reason for significant reductions in the regulatory burden on banks.

Many bankers and others naturally consider suggestions to reduce deposit insurance coverage dangerous because such a reduction might undermine public confidence in the banking system. Beyond this, many community bankers worry that it would weaken their competitive position in the industry if vestiges of “too-big-to-fail” remain in place.

These concerns are reasonable and understandable. After numerous increases in coverage over many years, capped by the sharp rise from \$40,000 to \$100,000 per account in 1982, reversing course might indeed reduce public

confidence in the short run. My own view, however, is that public confidence and the competitive positions of all banks would be strengthened over the longer pull, especially since the public is now much more conscious of the hazards and risks associated with deposit insurance in the wake of the savings and loan debacle. I believe the public is fully capable of understanding that reducing deposit insurance coverage would reduce risk in the banking industry by increasing (1) the degree to which depositors monitor the riskiness of individual banks and (2) self-regulation by the industry. I think it is very much in the longer-term interest of *all* bankers, whether from large banks or small ones, to help persuade the public of this view. The alternative is public demand for still more costly and burdensome legislation and regulation to protect the insurance fund. The latter seems to me to be clearly a bigger risk to the health of the industry than the immediate reaction to scaling deposit insurance back.

Other critics may claim that reducing explicit deposit insurance coverage would increase the risk of bank runs and panics like those of the 19th century. While 19th-century American banking lacked deposit insurance, it also lacked a central bank acting as lender of last resort. The Fed can prevent banking panics by supplying liquidity promptly and generously through the discount window and open market operations as the events surrounding the October 1987 stock market crash convincingly demonstrated. Scaling back deposit insurance would in no way diminish the ability of the Federal Reserve to stem financial panics.

The reason I am making so much of the need to reduce explicit deposit insurance coverage in one way or another is that I doubt very much that really meaningful regulatory relief—relief you can feel—will occur in the absence of such a reduction. Fortunately, some progress has been made in laying a foundation for reducing coverage in the future. For example, the FDIC, as mandated by FDICIA, recently completed a study of the feasibility of “tracking” the ownership of deposits by individuals across banks in order to gauge the feasibility of restricting coverage to one account per depositor. This is an important initiative, one I hope will be pursued. The FDIC has also studied the feasibility of partially privatizing federal deposit insurance. The FDIC would sell a portion of its deposit coverage in the private reinsurance market. This sale, in turn, would establish a market price for the insurance and indicate the restrictions private markets would impose on insured institutions. Also, private insurers are now offering supplemental deposit insurance directly to depositors. If such market arrangements prove viable, their availability might make reductions in FDIC deposit insurance coverage more palatable.

Before leaving the subject of the federal safety net, let me turn briefly to banking policy and the Fed’s role in the payments system. Since its founding, the Federal Reserve has played a central role in the nation’s payments system, and that role encompasses extensions of credit as well as transactional operations. Although it does not receive as much public attention as deposit insurance, there has been a growing awareness in recent years of the importance

of Federal Reserve credit and implicit guaranties to the payments system. This increased attention led initially to the introduction of specific regulatory constraints on payments system users, such as net debit caps for institutions participating in the Federal Reserve's Fedwire electronic funds transfer system. Further, under the Program for Payments System Risk Reduction, the Fed is reexamining the terms for such credit. As you know, the Fed will soon introduce a fee for daylight overdrafts in the reserve and clearing accounts of depository institutions, which is designed to increase the reliance on market forces to regulate the volume of intraday credit.

Payments system policy should continue to focus on the extent of the explicit and implicit guaranties the Fed provides and to strive to make the constraints on participants appropriate to the scale of the guaranties. As in the case of deposit insurance, financial market efficiency might well be improved by a more proscribed Fed credit exposure with consequently less encumbering regulatory constraints. The prospect of continued rapid technological advance in this area of banking lends weight to this view. It would be unfortunate indeed if the implementation of operationally more efficient payments system arrangements were stymied by regulatory schemes more appropriate to earlier technologies.

3. CONSUMER AND COMMUNITY AFFAIRS ISSUES

Let me turn finally to consumer and CRA issues. Obviously, no discussion of public policy toward banks would be complete without consideration of this increasingly important and, in some respects, contentious area. I can really only scratch the surface here. Consumer and CRA regulations may be viewed by some as a sort of quid pro quo for the benefits banks receive from deposit insurance and access to the discount window. Unlike basic safety and soundness regulation and supervision, however, community and CRA regulations play no direct role in protecting the safety net and therefore are not likely to be eased in response to scaling back the safety net.

As I see it, consumer and CRA laws and regulations have two basic purposes. First, consumer laws and regulations seek to ensure that lenders respect the basic legal rights of consumers in credit transactions—and most importantly that they not discriminate against particular prospective borrowers on the basis of sex, race, age, and so forth. Secondly, CRA regulations aim at encouraging and helping banks meet the credit needs of the communities in which they operate, especially for housing and community development purposes and always, of course, within basic safety and soundness constraints. These are not only reasonable but laudable objectives that reflect this nation's most cherished values. Few if any bankers dissent from these objectives.

There is, however, disagreement—and I think legitimate and understandable disagreement—regarding the detailed character of these regulations and the

way they are implemented in practice. Let me offer just a couple of comments in this regard.

First, credit markets, including markets for bank credit, generally allocate credit very efficiently among all creditworthy borrowers. With this in mind, regulators, and also consumer and community reinvestment activists and legislators, need to understand what you already understand all too well—that unduly burdensome, intrusive, and costly consumer and community reinvestment laws and regulations can well reduce the flow of credit and increase its costs unnecessarily to the very constituencies that activists, legislators, and regulators are trying to protect and assist. This is an instance of what Fed Governor Larry Lindsey calls the Law of Unintended Consequences, and unintended consequences are not at all unlikely in this area. The implication, of course, is a need for regulatory—and also legislative—restraint: adding new consumer and CRA laws and regulations only when there is a clear and compelling reason to do so, minimizing their intrusiveness, and continuously reviewing existing laws to find ways to reduce the burden they impose.

The second point I want to make is simply that we at the Federal Reserve Bank of Richmond want to do all we can to facilitate your compliance with consumer and CRA regulations and reduce the burden they impose on you. We see this as a fundamental regulatory obligation. I can guess how most of you react to someone who tells you he's from Washington and he's here to help you. At least I only have to say that I'm from Richmond and I'm here to help you. In any case, we have an active consumer and community affairs operation at our Bank that is separate from our examination staff. Our consumer and community affairs staff analyze local economic conditions across the District, with particular emphasis on the credit needs and development opportunities of moderate- and low-income households and communities. They offer specific and detailed information—both through conferences and in published form—designed to assist you in your compliance efforts. I hope you will take advantage of this assistance and let us know whenever we can be helpful to you in this area.

4. CONCLUSION

To quickly summarize the main points I've tried to make: First, regulations should be efficient, and since protecting the safety net is one of the central reasons for bank regulation, one way to promote regulatory efficiency is to try to aim for the minimum regulatory burden consistent with maintaining the actuarial soundness of the *existing* safety net. Second, there is a trade-off between the scope of the safety net and the burden of even the most efficient regulatory system. Consequently, beyond some point, reducing regulatory burden requires a reduction in the scope of the safety net and, in particular,

the coverage of the deposit insurance system. Finally, since consumer and CRA regulations have objectives other than protecting the safety net, they must be evaluated on different criteria. But activists who promote them, legislators who enact them, and regulators who implement them should be keenly aware of the Law of Unintended Consequences and the possibility that excessive zeal ultimately may be counterproductive. Attention to these points, I believe, can significantly enhance the contribution that necessary banking regulation can make to the economy's strength and its ability to grow.