ADAPTING BANK REGULATION TO A CHANGING FINANCIAL ENVIRONMENT

By

Thomas M. Hoenig
President
Federal Reserve Bank of Kansas City
Kansas City, Missouri

Bank Regulation Conference
Rayburn House Building
Washington, D.C.
March 25, 1996

Good afternoon. It is a pleasure to participate in this forum on bank regulatory reform. At first glance, a conference on rethinking bank regulation may seem unnecessary. After all, with record profits and strong capitalization, the banking industry is in its best condition in years, and recent changes in bank regulation will certainly help avoid a repeat of the problems of the last decade. So, why rethink bank regulation?

A principal reason is that financial markets are evolving at an incredibly rapid pace, bringing new opportunities and new risks to the banking system. With such change, we should at least acknowledge the possibility that today's regulatory system may not fit well in tomorrow's financial marketplace. Indeed, the current health of the banking system may be a mixed blessing if it makes us complacent about the need for future regulatory change.

A second reason for "rethinking" bank regulation is that we still have some unfinished business. A key issue is how to permit banks to undertake broad new activities without extending government safety nets or jeopardizing the stability of the financial system. Our difficulty in dealing with these issues is reflected in the contrast between our approaches to the banking industry's involvement in traditional investment banking activities and their participation in trading activities. As you know, much of the debate over Glass-Steagall reform has been about insulating the payments and deposit insurance systems from the additional risks associated with underwriting activities. Yet, at the same time, we have exposed these systems to the risks of proprietary trading activities and exotic derivatives. This may be perfectly appropriate, but my point is that this has occurred by accident more than by deliberate action.

My comments today are designed to look well into the future and to ask how we might alter our regulatory framework so that financial institutions can adapt to change without jeopardizing the health of the financial system. To this end, I will suggest two changes in our approach to financial regulation. First, instead of focusing primarily on preventing individual institutions from failing, we might explore better ways to strengthen the stability of the financial system to better withstand individual failures. Second, rather than focusing only on how to extend traditional regulation to new activities, we might think about alternative ways of isolating the payments system and safety net from these activities. Before elaborating on these points, let me spend a few moments developing the case for regulatory reform.

THE RATIONALE FOR REGULATORY REFORM

Over the past 25 years, financial markets have become increasingly competitive as technological change has reduced the costs of information gathering, processing, and transmission. Banks have faced greater competition for traditional activities such as commercial lending and deposit taking. Looking ahead, banks are likely to find their payments franchise under siege as well. Competition will continue to come from within the industry, from nonbank financial service providers, and from foreign financial institutions.

Banks have reacted to these pressures in a number of ways. They have altered the composition of their loan portfolios, substituting real estate and consumer lending for commercial lending. They have begun actively managing their investment portfolio to increase earnings. And, the largest banks have increasingly turned to off-balance sheet and trading activities to generate additional revenues. Taken together, these changes have substantially altered the risk profiles of many banks.

As you would expect, bank regulators are responding to these changes. We are progressively modifying capital requirements to account for the changing risk exposures of banks. In addition, we are in the process of extending the scope of prudential supervision by placing a greater emphasis on risk management.

In our current environment, these are very appropriate responses. Probing deeper, however, I believe there are emerging, difficult issues that need to be explored. The most significant is how we protect the payments and deposit insurance systems from the risks of new activities.

It is important to recognize that if we authorize new activities in banks, we also need to expand traditional safety and soundness regulation to protect the payments and deposit insurance systems. Such an approach by definition is intrusive. Moreover, given the complexity of new financial market instruments and activities, this approach is difficult and costly to implement. For example, examiners need to develop the expertise to understand and keep pace with the continuing evolution of asset valuation models and risk management techniques and processes. With only a slight degree of exaggeration, effective supervision may require examiners to know as much about a bank, its risk model, and control procedures as the rocket scientists who built the model and the management team who designed the risk management strategy. Even under the best of circumstances, I cannot help but wonder whether these risks can be adequately identified, measured, or controlled.

CRITERIA FOR JUDGING REFORM PROPOSALS

In light of these developments, this conference is very timely. As we compare and contrast reform proposals, however, I think it is important to develop some guidelines for choosing among alternative approaches. In my opinion, there are two criteria. First, a regulatory system must maintain financial stability while limiting the exposure of the safety net. Second, the plan should not impose unnecessary costs on the public or financial market participants.

I think most of us would agree that the primary reason for regulating banks is to promote financial market stability. Financial market stability probably means different things to each of us. To me it means that financial market disruptions should not significantly influence aggregate real economic activity. An important implication of this definition is that we should not be concerned about an individual financial institution failing, even a very large one, as long as the effects are not allowed to become systemic. By itself, the failure of a single, large institution is unlikely to have a great effect on aggregate output. When Drexel, Burnham, Lambert and

Barings failed, for example, there was no deep or lasting effect on economic activity.

However, as we learned from the banking panics of the late 1800s and early 1900s, failures that propagate through the financial system can have disastrous consequences for the real economy. Problems at a few banks can propagate through the system in a number of ways. Historically, runs by bank depositors and creditors were an important channel through which problems at individual banks became systemic. Correspondent relationships also have provided a link among banks. More recently, the exposure of banks to each other has increased through large dollar payment systems.

Over the years, we have attempted to reduce the potential for a systemic financial crisis through the safety net provided by the discount window and deposit insurance. As we know, however, the guarantees provided by the safety net have a serious side effect--the moral hazard problem that banks may take excessive risks.

At a minimum, therefore, I believe that any reform proposal must address both of these issues. It is not sufficient to reduce the exposure of the safety net if doing so increases systemic risk. Similarly, proposals to make the financial system more stable must also detail their implications for the safety net.

A second criterion for judging a reform proposal is that it is not unnecessarily costly. Of two plans with similar implications for stability and the safety net, I would prefer the plan that imposes the least cost on participants in the financial system. As I discussed earlier, the implementation cost of expanding the current system is one of the forces making it necessary to rethink regulation. In addition, the regulatory burden on the banking industry is a cost of which everyone here is keenly aware. Banks bear not only the direct costs of complying with regulations, but also the indirect costs of regulations that could put them at a disadvantage to other types of financial institutions. Finally, regulation can be costly to the economy as a whole if it inhibits financial innovation.

Clearly, some costs of banking regulation are inevitable--that is the price we pay for greater financial stability and protection against dishonesty or excessive risk taking. At the same time, I think it is just as clear that we want to minimize these costs. We want a regulatory system that is feasible to implement, that does not impose unnecessary burdens on the banking industry, and that is flexible enough to permit ongoing financial innovation.

THOUGHTS ON REGULATORY DESIGN

Let me now turn to how we might modify bank regulation to better meet these two objectives. One change involves a shift in the emphasis of regulation. I believe we should place less emphasis on a philosophy of protecting individual institutions and more emphasis on protecting the financial system from the effects of individual failures. A second change would alter how we protect the payments system and government safety net from the risks of complex new activities.

How could regulation be changed?

As I discussed earlier, the primary goal of bank regulation is to promote financial stability. Our traditional approach to preventing systemic problems is to prevent problems from occurring at individual institutions in the first place.

An alternative approach might be to design a mechanism that inhibits problems at individual institutions from spreading to others. Specifically, measures such as collateral requirements, debit caps, and pricing of intraday credit can be used to prevent large interbank credit exposures in the payments system. In addition, limits on interbank deposits and on loans to a single borrower can further protect the economy from problems at both bank and nonbank financial institutions. By limiting interbank exposures, problems at a particular institution would be less threatening to the viability of other institutions. As a result, an institution's failure--big or small--would be less threatening for financial stability.

In recent years, we have made substantial progress in reducing the vulnerability of the payments system to the failures of individual financial institutions. On large-dollar payments systems, such as Fedwire and CHIPS, the payments system is protected by fees on daylight overdrafts, collateral requirements, and loss allocation formulas. There is no question, however, that further progress can be made, particularly in the settlement of foreign exchange and other international transactions. For example, nonsynchronous operating hours continue to expose banks and other firms to considerable risks.

We have also made considerable progress in protecting the system from interbank deposit exposures. For example, an important part of FDICIA that often goes unnoticed is the provision that sets caps on some interbank deposits. Specifically, banks that have deposits at correspondents who are classified as less than adequately capitalized must limit their interday credit exposure to no more than 25 percent of their capital. With these limits in place, hopefully we will not feel compelled in the future to bail out a bank simply because it is big.

While limiting large interbank exposures helps maintain financial stability, it does not fully protect the deposit insurance system from the moral hazard problems. Short of doing away with deposit insurance generally, which in my opinion is neither feasible nor desirable, some safety and soundness regulation will be necessary for any institution protected by the safety net. What is not necessary, however, is to continue to protect all of today's banks with the safety net. Thus, in light of the costs and difficulties of supervising larger institutions who are increasingly involved in nontraditional activities, I believe the time may have come to limit their link to the safety net. In return, we would be able to scale back our oversight of their operations.

At a minimum, losing access to the safety net would involve two significant changes. First, institutions would not be allowed to issue deposits insured by the government. Instead, if they wanted to offer safe savings or transactions deposits, they would have to guarantee them in other ways, such as by collateralizing the deposits or by setting up an insulated narrow bank. Second, access to central bank discount window loans would be minimized so that these institutions would have a very limited option of seeking a loan from the central bank if they got into trouble.

What are the merits of the proposed changes?

I think that adopting the changes that I just outlined would go a long way toward meeting the two goals of regulation. By preventing large interbank exposures, financial stability would be far less threatened by any individual bank failure--large or small, global or domestic. Second, under the proposed system, we would not be extending the safety net as institutions adapt and expand into increasingly sophisticated activities.

This approach also meets the criteria of not being too costly. The regulation of banks involved in complex activities could be scaled back. In addition, the regulatory burden would be reduced for banks that retain access to the safety net because they would not be experimenting in complex new activities. The proposed changes also would allow banks to adapt to changes in the economic environment and would not inhibit financial innovation. Finally, the playing field would be leveled because all institutions engaging in complex activities--whether they are currently a commercial bank or an investment bank--would face similar regulatory constraints.

CONCLUDING COMMENTS

Let me conclude my remarks today by placing my thoughts on banking reform in a somewhat broader context. I recognize that fundamental reform of our bank regulatory system is a difficult and complex issue that is unlikely to happen soon. At the same time, I believe we can move toward this end by focusing on reducing systemic risks and continuing to limit interbank exposures. Indeed, such a step is a prerequisite for any reform proposal that would alter the scope of regulation or the use of the safety net. After all, there is little gain if we reduce the exposure of the safety net by simply shifting the risks elsewhere.

Where do we go from here? Clearly, I have presented only a preliminary sketch of how we might change bank regulation to cope with a changing financial environment. The feasibility of my approach--or of any of the other reform proposals discussed at today's conference--ultimately rests on the details of the program. We still have many questions to answer. For example, what activities should serve as the basis for excluding an institution from the safety net? What affiliations should be permissible? How should access to the payments system be structured? What macro events or financial crises would require us to provide liquidity to large institutions? While these are all difficult issues, I believe that discussions such as we are having today will enable us to design a better system of bank regulation for the future.