Financial Modernization: Implications for the Safety Net

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It's a pleasure to be here today as part of this panel on deposit insurance and financial modernization. Over the past 20 years, the world of finance has changed dramatically. During this period, we have seen phenomenal growth of new types of securities and derivatives markets, the globalization of finance and capital flows, and a blurring of the distinction between banks and other financial intermediaries.

These changes in financial markets have led to public debate among Congress, financial regulators, and financial industry participants about the appropriate role for banks, the so-called "financial modernization" debate. Much of this discussion has centered on the question, Should we expand bank powers? I believe, however, that this question is not very useful to us as policymakers. Modernization and expanded powers are clearly necessary to allow banks to adapt to the changing financial world. In my view, a more relevant question is, How does the expansion of bank powers affect the exposure of the deposit insurance system and the other components of the safety net?

The main point I want to make is that the path that banks are allowed to take in expanding their powers has important implications for the exposure of the safety net. In my remarks this morning, I would like to address four questions. First, why do we need a safety net? Second, why should we be concerned about extending the safety net? Third, in light of concerns about the structure of the safety net, is it feasible to reform the safety net? Finally, how does the approach to financial modernization affect the exposure of the safety net?

Why do we need a safety net?

Let me begin by defining what I mean by the safety net. The component of the safety net that receives the most attention is, of course, deposit insurance. The safety net, however, also includes the Federal Reserve's lender of last resort function and guaranteed final settlement on Fedwire, the Federal Reserve's large dollar interbank settlement system. As we think about the impact of new activities on the exposure of the safety net, I think it is important that we keep all three components in mind.

The safety net for the banking system has been put in place because of the unique role that banks play in the financial system—that is, because banks are, and will continue to be thought of as, "special." Banking is special because, unlike other industries, disruptions in certain banking activities have negative external effects that extend beyond banking and into other sectors of the economy. Indeed, banking problems can have a wide-ranging impact on overall economic activity. To limit the negative externalities associated with banking problems, most countries have chosen not to leave the fate of the banking industry solely in the hands of the market and to establish some form of a safety net for banks.

While banks have lost market share in business lending in recent years, one reason they are special is they still play a vital role in satisfying the credit needs of many sectors of the economy. Even when banks do not directly make the loans themselves, they often provide letters of credit and other guarantees that ultimately stand behind nonbank forms of credit. While the health of any single bank may have little impact on overall economic activity, broader problems in the banking sector can lead to a credit crunch and reduce economic activity at the regional, national, and even international levels. One need look no farther than the current banking crises in Southeast Asia to see how disruptions in bank credit flows can threaten not only the health of domestic economies, but also the health of economies in other parts of the world. Closer to home, we all saw how the banking problems in Texas and the Midwest in the 1980s and New England and California in the early 1990s reduced credit availability and slowed economic activity.

A second reason banks are special is their role in the payments system. A well-functioning payments system is essential to the workings of a modern economy because serious disruptions to the payments system impair the ability to complete transactions and adversely affect economic activity. The payments system has always revolved around banks since bank demand deposits serve as the principal non-cash means of payment. In addition, banks perform the function of clearing and settling almost all non-cash payments. The potential for systemic problems arising from payments failures, particularly payments failures in large-dollar payments systems, suggests that participants involved in clearing and settlement operations must be subject to greater scrutiny than other institutions. Thus, due to the crucial role of banks in credit markets and the payments system, some form of safety net seems important and necessary.

Why should we be concerned about extending the safety net?

Given the presence and significance of the safety net, my second question is, Why should we care if the safety net is expanded when new bank activities are permitted? The answer is that while the safety net helps protect the economy from the externalities associated with banking problems, it has its own unique side effects that are costly to the economy.

The most often mentioned problem is the moral hazard that banks will take excessive risks to the extent that explicit or implicit government guarantees remove the incentive for depositors and other creditors to monitor banks. In particular, the guarantees and reduced private sector monitoring mean that the cost of risk taking is lower for banks than for other financial institutions. To the extent they are allowed to do so, some banks will fund investment projects that might not otherwise be viable in the sense that the expected returns on the projects are too low. As a result, the moral hazard problem leads to a misallocation of credit, which is costly for the economy as a whole because it reduces economic efficiency.

The increase in risk taking combined with the reduction in private monitoring leads to an obvious reaction—namely, greater reliance must be placed on regulatory discipline. Regulatory discipline has its own cost for banks as it increases regulatory burden. Beyond banks, however, it is also costly for regulators who must keep up with the increasing complexity of ever changing bank activities and for the economy to the extent that regulatory rules and decisions lead banks to operate less efficiently.

As banks expand their activities, it is at least possible that the exposure of the safety net will rise. The concern for policymakers is that the additional costs associated with an expansion of the safety net will be greater than the additional benefits. Indeed, some believe the costs of the safety net as it is currently structured are already greater than the benefits.

Can we reform the safety net?

Given the concern about the costs of the safety net, it is natural to ask whether it is possible to reduce the exposure of the safety net by either reforming its structure or scaling it back. Proposals for changing the safety net have tended to focus on deposit insurance reform. Some of the options that have received the most attention include scaling back deposit insurance coverage, using subordinated debt to reduce the moral hazard problems associated with the safety net, relying on private insurance systems, and creating narrow banks.

Conceptually, I have considerable sympathy for reforming the safety net. The difficulty with changing the safety net, of course, is that it increases the potential for the systemic problems that the safety net was designed to prevent. I have argued elsewhere that safety net reform would be more feasible if we shift our regulatory focus from protecting individual banks to preventing problems at one or a few banks from spreading throughout system. By protecting the banking system in this way, individual institutions could fail without necessarily threatening the financial system. To the extent that systemic risk does decline, we could reduce the scale of the safety net and place greater reliance on market discipline because individual failures would be less threatening to the economy.

From a practical standpoint, however, I wonder whether we can realistically reform or scale back the safety net in the near term for two reasons. First, I do not see a public mandate for reducing safety net coverage. Second, even apart from whether an attempt to scale back the safety net would be politically feasible, it is unlikely that a reduced safety net would be credible. Recent experience in the U.S. and other industrialized and developing countries suggests that governments are inclined to bail out both depositors and other creditors to preserve stability in times of financial crisis even when there are no explicit guarantees. Again, the current events in Southeast Asia illustrate just how intense the pressure is to contain a crisis, even when it means some depositors and creditors might be protected. With the globalization of financial markets, few countries are willing to allow banking problems to jeopardize their reputation and access to international capital markets. At the same time, other countries have an incentive to lend assistance to prevent significant disruptions in trade and capital flows. Thus, while fundamental safety net reform should remain our long-term goal, the realities of the economic environment make such reform difficult to achieve.

How does the approach to financial modernization affect the exposure of the safety net?

If we assume then, that the safety net will remain basically as we know it today, how will financial modernization affect the exposure of the safety net? The answer depends on the approach banks are allowed to take in adopting new powers. One approach is to permit new activities to be conducted within the bank itself. The key policy issue raised by this approach is that it necessarily increases the exposure of the safety net to the new activities. As a result, the new activities would have to be regulated and supervised the same way as other bank activities.

Whether this is the best approach to financial modernization depends on the relative benefits and costs of allowing the bank to directly conduct the new activities. On the benefit side, allowing banks to engage in new activities that have synergies with existing activities may be efficient for the economy as a whole. In addition, while new activities may be risky, modern portfolio theory suggests that what matters is not the risk of individual activities but the risk of the overall portfolio of activities. Thus, it is possible that allowing banks to directly engage in new activities will reduce their overall risk through greater diversification.

On the cost side, allowing banks to directly conduct new activities expands the costs associated with safety nets that I noted earlier. To the extent that banks do not bear the full social costs of their activities, they may make loans or engage in other activities that might not otherwise be viable. In addition, this increase in moral hazard makes it necessary to extend regulation and prudential supervision to new activities. For example, new activities would have to be regulated under a safety and soundness criterion rather than the less extensive fraud and disclosure requirements for market-based activities. Thus, as activities are expanded within the bank, there is a greater regulatory burden for banks, greater costs for bank regulators, and perhaps less efficient decisions by banks.

The alternative to conducting new activities directly in the bank is to conduct them in affiliates or subsidiaries that are separated and insulated from the bank with firewalls. The advantage of isolating new activities in this way is that it would limit the exposure of the safety net to new risks, thereby better controlling the costs associated with extending the safety net. In particular, while some oversight would still be required, the degree of regulation necessary to control moral hazard would be substantially less than if the activities were conducted in the bank itself. In general, supervision and regulation could be designed to focus on transactions and other relationships between the bank and the affiliate. More specifically, the role of supervision would be to make sure that affiliates operate as separate entities, do not expose banks to additional risks, and do not gain an advantage over nonbank firms by exploiting the safety net.

The disadvantage of this approach is that although some of the synergies remain, there would be reduced direct benefits of new activities for the bank. In addition, some additional regulation and supervision would be necessary, although as I just mentioned, it would be less than if new activities were conducted directly by the bank.

Conclusion

In conclusion, I am convinced that financial modernization and expanded powers are inevitable, as banks must adapt to a changing financial world. For me, a key issue is the impact of modernization on the safety net. While the safety net serves an important role in helping to preserve financial stability, it also increases moral hazard. As a result, it is necessary to regulate banks differently than financial and nonfinancial firms that are not protected by a safety net. While I am in favor of safety net reform, it will require a sea change in attitude by the public, and this strikes me as unlikely as I view the past and current environment. Thus, as we proceed with financial modernization, we must first be aware of its impact on the safety net. Then, we should proceed only after a careful balancing of the private and social costs and benefits of new activities and, to the extent possible, in a way that limits further inadvertent extension of the safety net to new activities and firms.