After Deregulation: The Regulatory Role of the Federal Reserve

By Roger Guffey

Deregulation of the financial services markets, and of banking in particular, is proceeding swiftly on a broad front. Deregulation of interest rates through the elimination of rate ceilings on deposits is largely over. For product and geographic deregulation, however, the battle is now becoming intense. Product constraints, which historically have kept banks from offering certain financial services and nonbank firms from offering other services considered to be exclusively for banking, are crumbling away. Companies like Sears, Merrill Lynch, American Express, and Prudential are causing banks competitive fits. Moreover, the "nonbank bank" is further eroding banking's unique role in delivering financial services to the market place. Significantly, the "nonbank bank" also has become an alternative to the geographic restrictions of the McFadden Act and the Douglas Amendment.

While the nonbank firms have made inroads into banking, banks have broadened their presence in the markets by offering brokerage and other related services to the public. Local legislatures have permitted or invited out-of-state holding companies into their markets and are permitting banks to offer a broad range of insurance, real estate, and security services. Finally, the availability of computer technology is accelerating the industry's ability to provide financial services across the country.

From these events have come the fundamental questions of how changes in the financial services industry should be allowed to proceed and whether the current bank regulatory and supervisory framework is adequate to continue to promote a sound financial industry. Federal Reserve Chairman Paul Volcker has wisely asked for a moratorium on the spread of "nonbank banks" and other efforts to circumvent statutes requiring separation of commerce and banking. The Federal Reserve is not concerned so much by change itself but because it is occurring by regulatory fiat rather than through legislative process. Congress also is now studying the issue of a proper supervisory structure and is reviewing developments in the markets for banking and other financial services. Finally, Vice President Bush's Task Group on Regulation and Financial Services has been set up to review and perhaps recommend changes in the current regulatory struc-

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ture. We all hope that constructive suggestions will come forth to point the proper direction for the financial services industry and to clarify how the industry should be supervised.

As this review process has gotten under way, one disturbing opinion surfaces with some regularity. This opinion is that the Federal Reserve should no longer be involved in bank regulation and supervision. Other agencies and observers suggest that monetary and regulatory policies are unrelated in a broad policy sense and, therefore, regulatory matters need not be a direct policy concern to the Federal Reserve. The Association of Registered Bank Holding Companies and the American Bankers Association have suggested that the Federal Reserve's "regulatory role should be focused strictly on monetary policy formulation and implementation, through the elimination of the burden of regulatory and supervisory responsibilities not necessary to the conduct of monetary policy."

I do not agree with these comments and suggestions. I believe these statements are in error and I welcome this opportunity to offer my views regarding the importance to the Federal Reserve of its regulatory and supervisory role with the financial system. In doing so, I will discuss briefly my thoughts on why financial institutions should be subject to some supervision. In addition, I will discuss several reasons why the Federal Reserve must maintain its regulatory and supervisory presence, and then suggest some alternative regulatory structures that might work in the emerging financial industry. My ideas are based on my very strong belief that the Federal Reserve, as the nation's central bank and monetary authority, is principally responsible for the nation's financial stability. To effectively meet this responsibility, the Federal Reserve must have a central "hands-on" role not only in monetary policy, but in regulatory and supervisory matters as well.

WHY WE REGULATE FINANCIAL INSTITUTIONS

Various discussions I have had with bankers recently suggests that a subtle but significant reason for the desire to see the Federal Reserve out of regulation is the perception that the central bank has moved too slowly in deregulating the industry. These bankers suggest that the Federal Reserve has failed to recognize, in today's environment, that the growth and prosperity of the U.S. economic system relies on our willingness to allow risk into the economic system and our acceptance of some business failures.

Although I certainly concur that our markets must be competitive, I also believe that consistent economic growth requires a stable economic environment free from massive institutional failures and disruptions. Certainly, the Federal Reserve and others must not needlessly inhibit change, but we must also strive to assure that prospective change is consistent with the public interest and the need for a sound financial industry. Perhaps this point was best put by a prominent banker who, when comparing the Federal Reserve with other regulatory agencies, commented that, "Maybe if I had responsibility for the monetary health of the nation and also regulated the institutions which control the bulk of the nation's money, I'd act like the Fed."

The important role played by financial institutions in our economy, and by banks in particular, is to bring savers and investors together and facilitate the exchange of goods and services through the payments systems. Accordingly, they represent the channels through which national monetary and credit policies are implemented, and their welfare significantly affects the nation's level of employment and income. As we have seen recently, problems which develop in these institutions spread rapidly because of sophisticated lending and investing linkages.

The importance of these institutions to the vitality of the economic system has led the government to monitor their activities closely and to limit their activities to minimize the risk of failure. For example, Congress created the FDIC and the FSLIC to share responsibility with the Federal Reserve for avoiding a crisis of confidence in the financial system when individual institutions fail.

As the deregulatory process continues, the importance of financial institutions certainly will not diminish. Moreover, as the lines separating banking and commerce fade and the financial bonds between them become more complex, the risks to the system will increase proportionately. Thus, it is clear to me that some regulation and supervision will be needed regardless of the financial structure that emerges from the deregulatory process.

THE FEDERAL RESERVE'S ROLE IN REGULATION AND SUPERVISION

Statutory recognition

Recognizing that regulation and supervision will not diminish in the future, who should do the regulating? In response to this question, I would first note that the Federal Reserve's current role in supervision has not evolved as a patchwork quilt. Rather, it has developed rationally, recognizing that the Federal Reserve's central bank function is necessarily broader than the conduct of monetary policy alone. The Federal Reserve Act states that "The Federal Reserve System was established to furnish an elastic currency, . . . and to establish a more effective supervision of banking in the United States . . . " The Act clearly intends to provide the Federal Reserve with authority to establish reasonable behavior for financial institutions.

The Bank Holding Company Act also recognizes the importance of the Federal Reserve in influencing financial markets by directing the Federal Reserve to monitor and control the expansion of banking institutions into nonbank activities and to ensure the basic financial soundness of the bank holding company in its relationship to the bank. In addition, Congress assigned total responsibility for the administration of the Act to the Federal Reserve, regardless of the charter held by the subsidiary bank.

Interaction of monetary and supervisory policy

What these statues recognize is that the Federal Reserve's ability to control money and bank credit, and thereby influence real economic activity, would be compromised if it could not also influence the overall condition of the institutions through which money and credit flow. Because the strengths and weaknesses of financial organizations provide constraints within which money policy must operate, the Federal Reserve has a continuing direct interest in promoting strong banking organizations through careful supervision.

Also, to the extent that bank regulation affects money, credit, and interest rates, regulation should complement monetary policy goals. As an active participant in domestic and international monetary and credit markets, the Federal Reserve is best situated to ensure that regulatory policies are consistent with overall monetary policy objectives. For example, capital guidelines obviously involve issues of bank soundness but they also affect economic and credit activities. Capital guidelines, therefore, should be evaluated in light of other monetary policy and credit objectives and their impact on financial institutions and markets should be evaluated before such guidelines are changed or new policies implemented.

For these and other reasons, the Federal Reserve should retain the broadest perspective while emphasizing timely and coordinated monetary and supervisory policies.

The Federal Reserve's roles in managing financial crisis

On another level, it is a fact that in nearly every major financial crisis, the central bank is turned to for help. This role for the Federal Reserve derives from its position as a primary regulator of banks and bank holding companies, its daily participation in financial markets, and its close relationship with foreign central banks and other supervisory authorities. This role, coupled with the Federal Reserve's ability to provide immediate liquidity to the economy as lender of last resort, give the Federal Reserve a unique ability to stem the spread of financial problems and offers the broadest possible perspective to solving these problems.

You might recall, for example, that when U.S. financial markets came under stress following the failure of the Drysdale securities firm, the Federal Reserve played a central role in maintaining order in the market place. Other episodes, such as the Hunt silver affair, the failure of Penn Square, and the recent strains in the international credit markets resulting from foreign loan problems all created serious liquidity problems for some U.S. banks and other financial institutions. The Federal Reserve has been heavily involved in finding solutions to each of these problems while at the same time providing necessary credit and acting in the markets to preserve stability.

Some groups suggest that the central bank can work to solve these kinds of problems if it is simply supplied information from an independent supervisor. I disagree. Our ability to act immediately on problems requires that the Federal Reserve have the relevant current information and the people who can act decisively. Secondhand information is not enough. Moreover, decisions involving difficult tradeoffs among competing policy goals require access to timely information and an experienced staff. The ability to make proper decisions in these areas is not acquired on the sidelines, but in the trenches where supervisory and financial market operations are carried out.

Monetary and supervisory policy in a dynamic financial environment

In today's dynamic financial system, the effectiveness of monetary and supervisory policies also depends significantly on the Federal Reserve's knowledge of, and influence on, the development of new financial products and services. Although the Federal Reserve must not needlessly inhibit change, it should act deliberately to assure itself that prospective change is consistent with the public interest and a sound industry. The Federal Reserve can only achieve this goal if it has timely information gained, in part, through its direct involvement in the supervisory process.

We are now enmeshed, for example, in issues of the "nonbank bank," the movement of Sears and others into banking, and to what extent banks should be allowed to engage in commerce. The analysis of these events involves more than a review of potential competitive impacts on existing market participants. Such analysis also involves fundamental issues of money growth and issues of financial soundness which can be adequately addressed only if the central bank has a clear insight into how financial innovations operate and who they affect. Such knowledge will come to us most directly through the supervision function.

Alternative structures for regulating the financial industry

The clear statutory foundation for the Federal Reserve's major role in banking supervision and the compelling rationale for such involvement because of the interaction of monetary and supervisory policies in a dynamic financial environment—particularly in times of financial stress—suggest that the Federal Reserve's supervisory presence is essential. The question then becomes one of identifying what alternative supervisory structures would permit the central bank to continue in this role.

One alternative is that the current structure could be maintained. While the current multi-agency structure may not be the most efficient means of regulating, supervising and examining financial institutions, it has provided a good system of checks and balances to control the use of regulatory powers. Moreover, I have seen no convincing evidence that the current structure has failed to achieve its broad mandate.

However, if the desire for improved supervisory efficiency takes precedence over other considerations, the Federal Reserve's need for a major "hands-on" role in supervision could be met if the central bank was assigned supervision of the "pace setting" institutions most clearly able to affect financial markets. For example, the Federal Reserve might supervise the largest national and regional institutions or those engaged in activities crossing state lines. It might supervise institutions having assets exceeding a half billion dollars or those with bank or nonbank financial offices in more than one state. Institutions which confine their activities to a single state or which have less than a half billion dollars in assets could be supervised completely by the states or other regulatory authority. This approach might simplify the current supervisory structure while preserving our basic dual banking system.

CONCLUSION

At this point, I cannot say which alternative supervisory structure may ultimately be chosen. The groups now studying the issue must decide. However, I want to emphasize that efficiency should not be the principal criterion for determining how the financial industry should be regulated, supervised, and examined. A more important consideration should be that the Federal Reserve, as the central bank, remains ultimately responsible for the soundness of our financial system. To successfully meet this responsibility, the Federal Reserve requires the authority to regulate and to maintain close surveillance and supervision of the various activities of banks and diversified banking organizations. The Federal Reserve requires this authority to maintain the financial integrity of individual institutions; it requires this authority for proper administration of the discount window; and it requires this authority to implement both regulatory and monetary policies in a manner most conducive to enhancing the economic welfare of our nation.