
Bank Regulation: Asking the Right Questions

By Thomas M. Hoenig

Good afternoon. It is a pleasure to participate in this forum on bank regulation and financial reform. As this audience is well aware, the banking industry has come a long way over the past five years, both in Texas and across the nation. Indeed, with record profits and strong capitalization, the industry is in its best condition in many years.

Despite the current health of banking, it is important that we not become complacent about the need for banking reform. Financial markets are continuing to evolve at a rapid pace, bringing new opportunities and new competitive challenges to the banking industry. As I look at our existing regulatory structure, I believe that we have a very long way to go in modernizing financial regulations to allow banks to adapt to this changing environment.

If we are to modernize our regulatory system and allow banks the flexibility to adapt to financial change, it is essential that we ask the right questions about the purposes of bank regulation. Currently, much of the regulatory debate focuses

on the age-old question: Where do we draw the line between banks and other financial and non-financial institutions? As important as this question is, however, I believe that it begs a more fundamental question: Why do we regulate banks differently than other institutions? Unless we can answer this basic question, I fear that we may never achieve consensus on fundamental reform and will continue to rely on an incremental, reactive approach to bank regulation.

In my remarks today, I want to suggest that we need to look beyond traditional arguments for bank regulation that focus on protection of bank depositors and the federal safety net. In my view, a compelling reason for bank regulation is to maintain the integrity of the payments system. Focusing on the payments system provides us with insight into two aspects of the current debate over bank regulation. First, the payments system gives us a clear rationale for drawing lines between banks and other financial institutions. Second, focusing on the payments system may provide new ideas on how we should regulate banks as we move into the next century.

I. THE CHANGING FINANCIAL ENVIRONMENT

Let me begin with a look at some of the forces behind the need to modernize the financial system.

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The central factor promoting change in financial markets worldwide is new technology, which is dramatically reducing the costs of information gathering, processing, and transmission. Technological change is paving the way for many new financial services that were previously too costly or complex to be viable. Examples are the growth of mutual funds, the use of derivatives to manage risk, and electronic banking products.

Lower information costs and fewer production barriers have increased competition across different types of financial institutions. Initially, banks faced greater competition on the liability side of their balance sheets from money market mutual funds, brokered deposits, cash management accounts, and other instruments. More recently, similar developments have occurred on the asset side of the balance sheet, with banks experiencing competition from commercial paper, asset securitization, and nationwide credit card solicitations. And now, competition has extended to payments services, where banks once held a virtual monopoly. The most serious threat to the banks' payments franchise appears to be coming from electronic money and electronic payments services such as smart cards, Internet banking, and the provision of payments software, processing services, and communication linkages.

Increased competition, in turn, is putting greater pressure on bank profits, forcing banks to innovate and expand into a broader array of potentially profitable services, including trading, risk management, and investment banking activities. Such services represent a key source of profits for many banks and are becoming an important means of attracting and retaining customers. Thus, the lines between banking and nonbanking firms are blurring, making it difficult to recognize one institution from the other and to know whom or what to regulate.

II. LIMITATIONS OF THE CURRENT DEBATE

As you know, attempts to modernize our system of financial regulation have not been very successful, and the industry has had difficulty keeping pace with changes in financial markets. We have yet to set firm standards on what banks and nonbank institutions should do or how they should be regulated. For example, we have no consensus on the extent to which banks should be engaged in investment banking, trading, insurance, or other financial activities. We also are not clear on the role of deposit insurance for banks primarily focused on wholesale banking. With comprehensive reform stalled, we are relying on an incremental approach in which regulatory agencies, state and federal courts, and innovative firms gradually and, perhaps, haphazardly redefine what banking organizations may do.

While we have little choice but to continue on this path for the near term, there are several obvious problems associated with this approach—problems that should prompt us to take a closer look at what we should be doing. First, as banks take on broader activities, we risk extending further the safety net and the moral hazard problems associated with it. This implies, if history is an indication, that we will tend to expand regulation and prudential supervision to contain risks to the safety net rather than rely principally on the market and its discipline to address matters of risk management.

A second problem with the current approach is that it is costly and may not be cost effective, particularly as banking activities and their associated risks become more complex. Bank regulators and examiners often must play "catch up" in becoming familiar with new products, new activities, and the associated risk management techniques. While supervisors can handle this

task, it is a costly process for both supervisory agencies and banks, and may require supervisors duplicating steps that banks are taking on their own. Moreover, as our financial markets continue to evolve, we risk bearing the costs of having too much of the outcome directed by regulation rather than by what is most efficient for the economy.

Finally and most fundamentally, our current approach fails to re-ask the most important question: Why are banks regulated? If we address this question in the context of today's financial environment, we may be better positioned to define an appropriate balance between the regulator's and the market's role in overseeing the evolution of banking in today's changing marketplace.

III. WHY REGULATE BANKS?

Over the years, a number of reasons have been advanced for bank regulation. One traditional argument is based on protecting the savings of bank depositors. Historically, before the modern development of securities markets, households entrusted much of their savings to banks. Because such a large share of household wealth was dependent on the health of the banking system, a rash of bank failures could destroy the financial security of many individuals, which in turn, could severely disrupt economic activity.

To the extent that providing a safe savings vehicle was a valid reason for regulating banks in the past, I believe that it is a less compelling argument today because bank deposits no longer dominate household wealth portfolios. Today, households can diversify their assets into the many alternative savings vehicles provided by securities markets and mutual funds. Thus, we may be spending important resources protecting something that has much less significance for financial stability than it did 20 years ago.

A second argument for bank regulation—and in fact the argument around which much of the current debate revolves—is protection of the public safety net. Virtually every industrial economy has some form of government guarantees to protect the banking system. In the United States, the safety net includes deposit insurance, the discount window, and the settlement guarantees for payments that go through the Federal Reserve. While the safety net protects the banking industry, it also exposes the system to a moral hazard problem in which the industry assumes more risk than it otherwise would. Since taxpayers ultimately bear the risks to the safety net, many people argue that we need to regulate banks to protect the safety net.

While it is clear that the moral hazard risk brought on by the safety net makes regulation necessary, I think this reason begs the real question. Suppose, for a moment, that we eliminated the deposit insurance system. Would there still be a need to regulate banks or draw lines between the permissible activities of banks and other institutions?

I believe that under even this circumstance, there remains an important, although narrowly focused, case for bank regulation—which is, to assure a smooth functioning payments system. A well-functioning payments system is essential to the workings of a modern economy. People are willing to transact business because they have *confidence* that the payments media they use are worth their face value and can be used to make other payments. Serious disruptions to the payments system would impair their ability to complete transactions and adversely affect economic activity.

The payments system, in turn, has always revolved around banks. Bank liabilities, in the form of demand deposits, serve as the principal means of payment. In addition, banks perform

the function of clearing and settling almost all non-cash payments.

While few people would disagree about the importance of the payments system and the pivotal role played by banks, it is not immediately clear why bank regulation is necessary to maintain a well-functioning payments system. After all, our economic system is market-based, and we typically resort to regulation only if the market fails. I believe, however, that due to the absence of perfect information, the market left to its own devices will in certain circumstances fail to produce a safe and sound payments system.

As I noted earlier, the essential element of a well-functioning payments system is public confidence in the system. This confidence requires that the public believe that they can always access their transactions accounts upon *demand* at *par* value. Unfortunately, it is difficult for the market to ensure this confidence in a fractional reserve banking system because transactions deposits can be used to fund relatively illiquid loans or other risky activities. As a result, if confidence is lost and too many depositors want their funds, say, because they are concerned about their institution's financial condition, then not everyone will be free to redeem their transactions deposits upon demand at par value. Indeed, if enough depositors make a run on the bank, the bank could ultimately fail.

Of course, if such problems were limited to individual banks, the payments system would not be at risk. But the reality is that the risks extend beyond the individual bank to the payments system generally. One source of this systemic risk is the credit exposures among banks. Specifically, either through traditional lending arrangements or through the large-dollar payments system, problems at one bank can spread to other banks. More important, just the *uncertainty* about whether the exposures among banks are large enough for failures to

spread could cause a general loss of confidence, leading depositors to make a run on both problem and healthy banks. Thus, regardless of the actual condition of the banking system, the concern of depositors about their bank's solvency can lead to a general breakdown in confidence and failure of the payments system. Accordingly, I suggest that at the end of this century no less than at its beginning, a primary purpose of bank regulation is to maintain payments system confidence and prevent such breakdowns from occurring.

IV. IMPLICATIONS FOR FINANCIAL RESTRUCTURING

Given the importance of the payments system in maintaining financial stability, I believe it is essential that we incorporate discussion of the payments system into the debate about bank regulation and financial restructuring. Focusing on the payments system gives us an important rationale for drawing lines between banks and other financial institutions. In addition, the payments system provides insight into how we supervise and regulate banks and the relationship between banks and other institutions. In my remaining time this afternoon, I would like to touch briefly on these two issues.

As I noted at the beginning of my remarks, much of the current debate focuses on where to draw the line between permissible and non-permissible bank activities. As you know, there is a wide range of proposals for changing the scope of bank activities, ranging from narrow banks that have virtually no powers to universal banks that can do virtually anything they want. The common thread among the various narrow bank proposals is that banks would only issue transactions deposits and that these deposits could only be invested in safe, money market instruments. Under these proposals, risky assets currently held by banks would have to be divested into affiliates or other institutions. On the other end of the spectrum, universal banks would be

able to engage in any financial activity, and possibly even in commercial activities.

These alternative proposals have been intensively studied and widely debated. While much of the discussion has centered on protection of the deposit insurance system, very little attention has been paid to the payments system. For example, would the expansion of activities under universal banking increase the risk to the payments system? If so, what would we need to do to protect the payments system? Would we have to significantly increase regulation or the scope of the safety net? If so, is such an increase in regulation and the safety net desirable or cost effective? Conversely, would a narrow banking framework really protect the payments system? While narrow banks would seem to be protected against the risks of loan or investment losses, what about intraday credit exposures among narrow banks from the large-dollar payments system? Thus, while we each may have our preferences about how banking evolves, it is essential that any proposal explicitly indicate how the integrity of the payments system would be dealt with and protected.

In asking where to draw lines between institutions, it is also important that we ask not only what new activities banks should do but also what banking activities should be permitted to nonbank institutions. My impression is that most of the restructuring proposals are somewhat fuzzy about the banking activities of nonbank institutions. In any of these proposals, I think it is important that we clearly specify what access nonbanks will have to the payments system and how the payments system can be insulated from the risks of their activities. A similar question arises as we look ahead to a fully electronic payments system and the possibility that nonbanks will issue electronic money. In such a world, I believe it is important that we continue to focus on maintaining public confidence in the integrity of the payments system.

In addition to helping draw the line between banks and other institutions, focusing on the payments system provides insight into how we should regulate banks. As I noted earlier, one of the key sources of systemic risk in the payments system is the interconnections among the banks that make up the payments system. Obviously, one way of preventing systemic problems in the payments system is to prevent the failures of individual banks. Indeed, historically, much of bank regulation has focused on maintaining the health of individual institutions. As I have suggested, however, this approach is becoming increasingly costly and difficult, particularly as banking activities and their associated risks become more complex.

An alternative strategy for banking regulators is to continue along the path designed to ensure that problems at one or a few institutions do not spread in fact or in perception throughout the payments system. 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. Limits on interbank deposit exposures can further insulate the economy from problems at both bank and nonbank financial institutions. Indeed, regulators in the United States and other countries have recently taken many of these steps to protect their payments systems. By protecting the payments system in this way, individual institutions can fail without necessarily threatening the financial system. Furthermore, it opens greater opportunities for these institutions to broaden the scope of their other activities with less regulatory oversight.

V. CONCLUSION

In conclusion, changes in financial markets have had a significant effect on the way banks do business. To allow banks to compete and keep pace with these changes, we need to develop and

implement a plan for regulatory reform that is flexible and able to adapt to both past and future changes in financial markets. In recent years, we have made some regulatory changes, but they have occurred in a slow, piecemeal fashion. In my view, one of the major obstacles to achieving consensus on a plan for reform is that we often lose sight of the reason that we regulate banks in the first place. What I am suggesting here is that a primary reason for regulating banks is to

maintain confidence in the payments system. By focusing our discussion on the payments system, I believe we can make significant progress on the regulatory issues that are confronting us today. Indeed, with the payments system protected, there may be less need to rely on regulation and supervision of individual institutions, allowing these institutions to be more responsive to market discipline and better able to adapt to a changing financial environment.