Can Regulatory Reform Prevent the Impending Disaster in Financial Markets?

By Franklin R. Edwards

Introduction: an aura of uneasiness

A deep current of unrest flows through financial markets these days, carrying with it a feeling that things are, in some way, out of kilter. While no one is quite certain of the precise reasons for it, there is a general uneasiness about whether the fabric that binds and solidifies our financial system is coming unraveled. In recent years,we have witnessed spectacular bank failures (such as the Continental Illinois Bank), seen the collapse of two state deposit insurance systems, and been told that the prestigious Federal Savings and Loan Insurance Corporation (FSLIC) is in the red by some $30 billion. Newspapers carry daily stories of the billions of dollars of loans made by banks to third-world countries that will never be repaid, but will have to be written off as bad debts. Banks and thrifts located in areas dependent upon the health of the energy and farm sectors are in deep trouble; many will fail. The total number of bank failures this year has already surpassed historical annual highs. Even the future of the mighty Bank of America is in doubt.

Intertwined with this shaken financial structure is the world of glittering high finance, where the successful (and the dishonest) amass large fortunes in only a few months or, at most, years, and where success is expected to come early to the best of our university graduates. A seemingly endless stream of innovations—swaps, coupon-stripping, futures, options, leveraged-buyouts, and so forth—occupy the attention and the resources of our best institutions. In this world, internationalization, global capital markets, and 24-hour trading are the vogue. In the lowly world of banks and thrift institutions we are still debating the feasibility of permitting Citibank to operate in New Jersey, or Illinois, or Texas, knowing full well that it already operates in every major coun-

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try of the world. In high finance, anything is possible and nothing seems prohibited, while in the other world banks and traditional financial institutions seem entrapped in a static environment encumbered by archaic regulation. It is little wonder that these inconsistencies and the resulting pervasive bickering among financial market participants and regulators have begun to make us question the logic of the current financial structure and to ponder whether regulators are still playing a constructive role in guiding market developments.

Concern about the stability of the financial system is also being reinforced by persistent macroeconomic disequilibria. A continuing government budget deficit threatens us with uncertainty about debt markets and interest rates, and persistent trade imbalances have wrought currency instability and a threat to free-trade relationships. The recent behavior of the stock and bond markets is testimony to this unrest. More volatile than at any time in recent history, these markets epitomize the fragile nature of expectations about the future. We seem to be balancing on a knife-edge of stability, ready to be toppled one way or the other by economic or political news that either reinforces or shakes our view of the future.

The world is changing around us, in spite of us, and there is no clear path or end in sight. We have a financial system born in the 1930s in the depths of our greatest economic catastrophe, formulated and promoted as the fail-safe system of the future. Pictures of bank failures and bank runs, with their long lines of dispirited and desperate people, provide a vivid reminder of the intimate relationship between our economic health and the soundness of our financial institutions. More than 50 years have gone by since the collapse of the 1930s, years of relative calm and prosperity. During those years, our financial system, while buffeted by occasional shocks and imbalances, performed admirably. Financial institutions of every type blossomed.

The idea that this system may in some way be seriously flawed is an alien thought. The notion that it should be drastically changed shocks us. "If it works, don't change it" is a philosophy that needs no proselytizing. But the world is changing, and our financial system is no longer working well. Worse, it is failing in ways that are not immediately obvious, giving us a false sense of comfort. The seeds of change, planted in the 1960s, have long ago sent their shoots into every corner of the financial landscape. Institutions are being entangled and will eventually be smothered unless the financial system is restructured to accommodate these changes.

Change, of course, is never easy, and changing something that has been almost sacrosanct for more than 50 years is an intimidating prospect. With longevity and prosperity come strong private-interest groups. We have done our best to nurture a system of heterogeneous institutions, insulating and protecting them from one another with the heavy hand of regulators. Institutions have responded predictably: where similar interests are at stake, they have banded together to form powerful special-interest groups, besieging Congress and regulators either for special privileges or to block intrusions into their preserves. Special-interest groups are the natural predators of change. When threatened by it, they erect still more formidable barriers to contain it.

This political-economic process is presently playing itself out, to the detriment of the entire country. The winds of change embracing us are seeping through the hastily erected barriers faster than they can be built. Once breached these barriers will crumble with electrifying speed, taking with them in a crash many institutions that appear sound today but are in reality teetering on the edge of instability.

It is important that we not allow this to happen; that we orchestrate this change, and not allow it to crash down upon us with unpredictable consequences. We have a governmentally-constructed and regulatory-maintained financial edifice, one that is not the product of natural market forces. It is a system neither prepared nor capable of coping with the market changes inundating us. We cannot close our eyes to its fate without serious risk.

The time has come for us to reach a consensus. We must determine the financial system of the future and put in place a compatible regulatory system. Barriers that prevent us from achieving these goals, or that threaten present stability, must be quickly dismantled, and regulations needed to assure financial soundness either retained or developed. There must also be provisions made for transitional problems that will be encountered in moving from an old to a new system.

A key to accomplishing this is to identify and discard myths that have been a continual obstacle to the restructuring of the financial system. Another critical step is to agree on fundamental goals of financial regulation and on the nature of government intervention that is needed to achieve these goals. Finally, we need to commit to a financial system that provides for the maximum degree of free-market discipline for our financial institutions, consistent with a stable financial environment.

These objectives may seem like a tall order to those of us who have long been enmeshed in the complex maze of financial regulation, but I believe there is more agreement among us than is commonly either realized or acknowledged. A first step is, therefore, to identify key principles and concepts on which we agree or disagree. Such an understanding is fundamental to establishing a firm foundation upon which to construct a new regulatory structure.

Why we must act

We must act soon. We are sitting on a ticking time-bomb with an uncertain timing device. Most of you will find this declaration startling, even unbelievable. Things do not seem that bad! True, some institutions are going bankrupt, but most are operating in the black. How can conditions be that threatening?

The situation today is similar to the rotting frame of an old house. Each piece of supporting timber has rotted from the inside. From casual observation, it is impossible to determine whether the supports are sound. A few probes with a sharp instrument, however, quickly reveals that the timber has rotted, its ability to support the house gone. Despite this enfeebled condition, the house miraculously stands, until one day a brief but intense gust of wind takes it down with a crash.

Is this an alarmist analogy? Yes. Does it misrepresent the current situation? I do not think so. The reason appearances today do not reflect reality is due to a combination of deposit insurance, fictitious accounting, and regulatory procrastination.

The deposit insurance crisis, and that is what it is, is increasing with every passing month. It is not a secret: almost everybody knows, even Congress. But its resolution is not a simple matter.

The insurance crisis is gathering in force because the numbers are getting larger.[1] We already know that the FSLIC is some $30 billion short. Were it to close only those thrift institutions it knows to be already insolvent and to repay depositors, it would need at least $30 billion more than it now has. Its solution, therefore, has been not to close these institutions, but to pretend that they are not insolvent.

This is not a neutral policy. It does not simply maintain the status quo; it makes things worse. The managements of the insolvent institutions have almost nothing more to lose. They have already lost their institutions, for all practical pur-

1 Edward J. Kane, *The Gathering Crisis in Federal Deposit Insurance*, Cambridge: MIT Press, 1985.

poses. But they still have some of the deposits of their customers, and the hope that a miracle will revive them. It is a small step for them to try to help this miracle along by their taking a last, desperate gamble with their depositors' funds.

Football fans call this the "long-bomb" phenomenon. In a football game, with time running out, the team that is hopelessly behind begins to resort to the high-risk, seldom successful play—a long pass into the opponent's end zone. There is always a small chance that it may work!

In a football game, the failure of this "long-bomb" strategy is of little consequence: they would have lost the game anyway. It is there that the analogy with today's thrift crisis ends. The consequences of a failing thrift institution unsuccessfully pursuing such a high-risk strategy are serious: the institution goes deeper under water and its depositors are at greater risk. The institution's assets shrink even more, making the imbalance between its assets and liabilities greater. When the institution is finally declared insolvent, the FSLIC has an even bigger bill to pay. It must refund insured depositors their monies, using more of its own (and taxpayers') resources to do it.

Why would depositors leave their funds with insolvent institutions and be vulnerable to "long-bomb" risk-taking? Because, of course, they are insured by the government, and are confident that whatever the outcome they will be repaid by the government.

Thus, we have the makings of an escalating crisis. FSLIC, without adequate resources, is unable to close already insolvent institutions, but at the same time is unable to control risk-taking by these institutions. In addition, these institutions have every incentive to take even more risk, and ultimately, to fall deeper into debt. FSLIC's debt is steadily mounting. It is a matter of time before thrift depositors understand this too and begin to wonder about either the ability or the resolve of the government to stand by its guarantees. When this happens you have the classic "bank-run": depositors will indiscriminately remove their funds from solvent as well as insolvent thrifts, since they will not be able to distinguish one from the other.

This threat may extend to banks as well, and not only to thrift institutions. Those with deposits at banks look to the Federal Deposit Insurance Corporation (FDIC), just as thrift depositors look to the FSLIC. How good is the FDIC if the FSLIC has been let fail? Past decisions by depositors and other investors have been made on the basis of our present financial and regulatory structure. Deposit insurance and government guarantees are an integral part of this structure. Any loss of confidence in these guarantees risks serious repercussions for all institutions.

Congress is fiddling while risk is mounting. At best, it will eventually bail out our insurance funds, imposing a tremendous cost on taxpayers. At worst, it will do nothing until we have a panic on our hands. In either case, it will be acting irresponsibly late.

The growing insurance crisis is exacerbated by our antiquated accounting conventions and by the present regulatory policy of increasing "forbearance." The health of many financial institutions today is illusory. Their asset values reflect inflated historical values and not actual current market values. Their equity values are commensurately overstated. There is little doubt that were we to restate assets and liabilities on the basis of sensible market-value accounting principles, many financial institutions would become insolvent overnight.

The absence of realistic accounting conventions also causes regulators to defer acting even when they know they should. Instead of closing institutions early, when losses to the insurance fund (and taxpayers) are minimal, they defer action, hoping either for a miraculous recovery or that such action may be postponed until they are no longer in office. Were the balance sheets of institutions to reflect realistically their weakened condition, regulators would undoubtedly be under greater public and congressional pressure to act. Even depositors, despite the insurance guarantee, might begin to view with a jaundiced eye the wisdom of lending funds to insolvent entities. Better accounting means better information, and with better information the rot would be discovered and remedied before it could threaten the safety of the entire house.

The current policy of increasing regulatory forbearance (or forgiveness) is ill-advised. While its equity objectives are understandable, perhaps even laudable, it is dangerous and doomed to failure. The basic assumption underlying this policy is that future changes in the economy will occur that will rescue troubled institutions. Energy-troubled banks will return to good health when energy prices go back up, making the energy sector prosperous again; or, farm-troubled institutions will recover when farming does. In the meantime, losses are mounting.

Regulatory forbearance can work, and sometimes has worked, but it will not work this time. While some of our current problems are of a cyclical nature, the most critical ones are not. They are the result of structural changes in financial markets. These changes will be permanent features of the future financial landscape. They are not ephemeral fissures in the existing structure.

A major change has been the erosion of barriers to competition, which separated financial institutions and markets from each other. Deposit insurance, instituted during the 1930s as a supplement to the Federal Reserve, was directed at protecting small depositors, preventing bank runs, and protecting the payments system from disruption. In return for this federal guarantee and as a safeguard to the federal deposit insurance system, depository institutions were wrapped in protective regulation, which they accepted as a necessary component of the system. It was, if you will, a regulatory (or government) fostered cartel, complete with rigid entry barriers and regulations to prevent "destructive" competition. (An example was the interest rate ceilings imposed on deposit accounts.)

The result was to create an artificial financial structure characterized by thousands of small disparate financial institutions. We had institutions specializing in only mortgage loans, or consumer loans, or business finance, or trust services, and so forth. We had banks with thousands of branch offices, while others were prohibited from opening an office across the street from their main office. We had thousands of tiny institutions operating in insulated local markets, where competitors were unable to go, together with giant institutions operating in distant cities, like they were on different planets of the solar system. We had U.S. institutions doing in London and Frankfurt what they were prohibited from doing in New York and Chicago, and foreign banks doing in New York and Chicago what U.S. banks could not do in the United States. It was a regulatory-created and nurtured edifice, not the child of natural market phenomenon, and it could only be sustained by protective regulation.

Economics, technology, and competitive developments combined to tear down these protections. What is left is deposit insurance and government guarantees without the regulatory safeguards designed to support them. High and volatile interest rates (and therefore funding costs), sharply reduced information and communication costs, and the globalization of capital markets together with intense international competition have all played a role in eliminating competitive barriers. Interest rate ceilings on deposits have been removed, opening up competition for funds; the geographical operations of institutions has widened substantially; there has been a frantic search for new sources of earnings and ways of diversifying, which has led to U.S. banks going off-shore and to the development of the Eurodollar market and foreign financial centers. Most of all, the new world of open competition has destroyed the cartel-like world of old, threatening the viability of many of the formerly insulated financial institutions.

Discarding old myths

A first step in moving to a new and more sustainable system is to discard certain myths that have prevented us from undertaking significant regulatory changes. These are false beliefs about what are necessary features of a financial system, about the role of government intervention, about regulation and its costs and effectiveness, and about what are necessary safeguards against a costly financial collapse.

Myth 1: Deposit insurance is necessary for financial stability.

Deposit insurance will undoubtedly be a central element of any new financial structure. It has occupied such a position for the last 50 years, and is understandably viewed as essential to a well-functioning and stable financial system.

Deposit insurance has had twin goals: to protect small depositors and to prevent bank runs. Its role as preventor of bank runs is seen as being integral to financial stability. Without it, what would prevent depositors, fearful of bank insolvencies, from engaging in the wholesale withdrawal of funds from the banking system? This view has led in recent years to the continued expansion of *de facto* (if not *de jure*) deposit insurance coverage, to where today such coverage may be as great as 100 percent of a bank's liabilities.

It is a falsehood that deposit insurance is necessary for financial stability. Indeed, under certain conditions, such as we have at present, it may even contribute to instability. Proof that deposit insurance is unnecessary is everywhere: many countries, both today and historically, have enjoyed financial stability without having a system of deposit insurance. While it is true that the financial structures of many countries are quite different from ours, the point remains valid: as a general proposition, deposit insurance is not required for stability. There is, in addition, little evidence to indicate that under normal market conditions a bank failure (or failures) will precipitate a run on depository institutions.

The primary safeguard against bank runs and financial panics is, and has always been, the central bank, with its unlimited lender-of-last-resort capability. Used intelligently and judiciously, this power is all that is needed to protect us against irrational and episodic financial panics. Deposit insurance is superfluous.[2]

As a country, we turned to deposit insurance out of distrust of the Federal Reserve. The Federal Reserve failed us miserably in the 1930s and, as a consequence, deposit insurance was adopted as the panacea. Deposit insurance would presumably remove the human element: we would not have to rely on the discretionary judgment of central bankers but could depend instead upon a failsafe institutional structure.

In reality, we substituted one set of regulators for another. We put our trust in regulators assigned to administer and protect the deposit insurance system, rather than in central bankers, and these regulators are failing us in the 1980s just as the Federal Reserve did in the 1930s. By failing to act and by following an expanding policy of regulatory forbearance, regulators are failing to protect our insurance system and are sowing the seeds of a financial disaster. In the end, it will be the Federal Reserve on which we must rely.

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[2] Anna J. Schwartz, "Financial Stability and the Federal Safety Net," unpublished, prepared for the American Enterprise Institute's project on Financial Services Regulation, 1987.

If there is a role for deposit insurance in the future it is as a guarantor of small depositors. The rationale for such a role is one of "social justice" rather than "economic efficiency." We might want to consider retaining some deposit insurance for this purpose, as long as its coverage can be kept narrow. For the purpose of financial stability, however, deposit insurance should be discarded in favor of a more pervasive central bank role as lender-of-last-resort. Once this is done, a number of promising avenues for financial reform will be open to us.

A lender-of-last-resort policy also will not be subject to the same moral hazard problem that has undermined deposit insurance. The primary objective of the central bank should not be to rescue individual institutions but to provide market liquidity (through, for example, open market operations). If institutions are in general solvent, the provision of ample market liquidity should be adequate to prevent bank runs. The task of assuring institutional solvency should not fall to either the central bank or deposit insurance, but rather should be the result of a soundly conceived and maintained financial and regulatory structure. If there is pervasive institutional insolvency, not even the Federal Reserve can help.

If direct central bank lending to individual institutions were to become necessary, it also would not carry with it the same predictable and dependable subsidies as has deposit insurance. It would not, for example, result in a continuous divergence between what institutions pay for funds and what they should pay. Managers could not as easily internalize in everyday decisions the mere possibility that central bank funds might be forthcoming as they can the deposit subsidies on their funds.

Myth 2: Bank failures and financial instability are the same.

It is often thought that bank failures cannot be permitted without endangering the entire financial system. Similarly, bank failures are equated with high social costs. These are inhibiting notions. They keep regulators from closing banks when it would be prudent to do so.

Bank failures need not mean market disruption, or even customer disruption.[3] They can very often be accomplished by simply replacing old owners with new owners, where the losses are borne by the old owners. This is possible if regulators close banks in a timely manner, or before the market value of their equity is less than zero. The longer regulators wait to act, the more difficult it is to find new owners, and the higher the social costs.[4]

Bank failures (as well as the failure of other financial institutions) should be expected. They are an essential part of a competitive world. Competition without failure is anomalous. Failures are part of the engine that makes competition work. They must be anticipated and planned for. When that is done, bank failures and financial instability are not synonymous.

Myth 3: Effective monetary policy requires narrowly-defined banks.

An old obstacle to restructuring the financial system is the view that monetary policy cannot work unless the payments system is controlled by narrowly-defined banks. The argument is sometimes couched in terms of the uniqueness of the money supply and the necessity of regulatory-mandated minimum reserve requirements. In recent years, there has been a blurring of what constitutes "money" (or "transaction" balances),

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[3] George Benston and George Kaufman, "Risk and Failures in Banking: Overview, History, and Evaluation," in George Kaufman and Roger Kormendi, eds., *Deregulating Financial Services*, Cambridge: Ballinger, 1986.

[4] George Benston and George Kaufman, "Risk and Solvency Regulation of Depository Institutions," unpublished, prepared for the American Enterprise Institute's project on Financial Services Regulation, 1987.

and of which institutions are providing (or should provide) such balances. The fear is that if these balances are not concentrated in "banks", or other commensurately regulated entities, the Federal Reserve will no longer be able to control the "money supply."

This fear is unfounded. The Federal Reserve is capable of controlling the monetary base, whatever the financial structure. The need for mandated reserve requirements is also questionable, although in principle they could be imposed on any institution (not only banks). Finally, there is no clear association between different types of financial structures and either the stability of the money supply or a central bank's ability to control money. In addition, there is evidence that the maintenance of artificial (or regulatory-induced) capital market barriers between different kinds of financial institutions and markets may inhibit effective monetary control. Our experiences with Regulation Q taught us this lesson well.

Thus, monetary policy can be effective even if "banks" are not the only providers of "money." The goal of effective monetary control cannot be used to justify a regulatory policy that mandates narrowly-defined banks.[5]

Myth 4: The separation of banking and securities activities is necessary for financial stability.

There are many arguments about why banking and securities activities should or should not be mixed. Some of these should be taken seriously; some should not. One that should not is that the mixing together of such activities will undermine the soundness of our financial system.

There is little dispute that, in principle, mixing banking and securities activities provides financial firms with greater diversification opportunities, which should enhance profitability and risk management. This should contribute to greater financial stability, not less. The empirical evidence that we have on banks suggests that greater diversification is valuable. Similarly, there may be economies of scale and scope that can add to profitability.

The major arguments against mixing banking and securities activities are potential abuses related to perceived conflicts of interests and to the "upstreaming" (or transferring) of profits or assets from the bank to associated entities, thereby weakening the bank. These arguments are related more to the corporate form employed—the holding company entity—than to the mixing of banking and securities activities. There is nothing inevitable about the holding company form of organization. It is also not obvious that abusive "upstreaming" practices by holding companies cannot be controlled.

Stripped of this controversy, there is nothing unique, or intrinsic, to securities activities that make them inherently dangerous for banks. They are not, for example, more risky. Nor do they pose conflicts of interest problems more severe than already exist in many banking and securities firms. Further, by permitting more open competition among banks and securities firms there should be less abuse of conflict situations in the future.[6] Finally, other major countries have permitted the mixing of banking and securities activities without undermining the soundness of their financial systems. Indeed, our own banks have done a securities business abroad for years without adverse consequences.

Myth 5: The payments system requires the separation of banking from commerce.

Some have argued that unless banks are kept

[5] Marvin Goodfriend and Robert King, "Private and Central Bank Provisions of Liquidity," *Ibid.*, 1987.

[6] Anthony Saunders, "Bank Holding Companies: Structure, Performance and Reform," *Ibid.*, 1987.

"pure," free of the risk associated with commercial activities, there will be an unacceptable risk of "settlement failure" in our payments system. This argument largely reflects concern about the private "wire transfer" segment of the payments system and, in particular, about CHIPS. CHIPS is an electronically linked network of over 130 large banks that processes about 90 percent of the international interbank dollar transfers.

It is feared that the failure of a single CHIPS bank to settle at the end of the day may generate a systemic risk of widespread failure, with a result similar to a bank run. A settlement failure may have a chain reaction, rendering some banks temporarily illiquid and others possibly even insolvent (which may occur if creditor banks are ultimately not able to collect a substantial percentage of what they are owed from the bankrupt institution). Such systemic risk is not present to the same degree in the Fedwire system because the Federal Reserve guarantees transfers when the receiving bank is notified of payment.

Settlement failures in wire transfers are logically quite similar to other credit risks that banks face. The only distinction is that daylight overdraft risks are concentrated among only the largest banks. There is, therefore, no "payments system risk" separate and distinct from the general issue of financial institution soundness. If mixing banking and commerce is in general unsound, it is also unsound from a payment system risk perspective. If such activity is not unsound, there is no special payment system risk problem. The only issue is the soundness of financial institutions.[7]

Myth 6: Small is "best."

The present financial structure is populated with thousands of small banks and financial institutions. Possibly as a result, it is sometimes thought that a system characterized by large financial institutions is not desirable.

Two fallacies underlie this view. First, the structure we now have is artificial: it is the child of regulation. It is a structure nurtured and preserved by restrictive regulation. Both geographic restrictions (such as branching prohibitions) and product restrictions (for example, banking versus securities activities) fostered and maintained this structure. Without them, it is doubtful that the financial structure would look anything like it does today. A quick glance at foreign countries confirms this: they have far fewer and relatively larger financial institutions. In addition, the current erosion of regulatory barriers to competition has had the predictable effect: reducing the number of institutions and increasing the size of those remaining.

Second, there is no evidence that a system with fewer and larger institutions is inferior. With fewer regulatory barriers, the general level of competition will increase, and not diminish, as is sometimes feared. Cost studies indicate that large banks are no less efficient than small banks, and there is no reason to think large banks pose a greater soundness problem. There is, finally, no reason to believe that a structure of fewer and larger banks (or financial institutions) creates additional problems with respect to conflicts of interest, the allocation of credit, or the exercise of political influence.

There is, therefore, no convincing reason to prevent market forces from working to alter our financial structure (governed, of course, by the enforcement of the antitrust laws). If the result is fewer and larger institutions, this may be "best." A structure of small, artificially protected, institutions is definitely not optimal.[8]

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7 Mark Flannery, "Public Policy Aspects of the U.S. Payments System," *Ibid.*, 1987.

8 Franklin Edwards, "Consolidation, Concentration, and Competition Policy in Financial Markets: in Past and the Future," *Ibid.*, 1987.

Fundamentals of a new financial system

Discarding these myths does not by itself delineate the contours of a new financial system. It does free us to consider a broader range of possibilities. All of these alternatives, however, must satisfy, or be consistent with, a number of fundamental goals. Identifying these goals is essential to designing a new system and to defining the proper scope of government involvement.

There are four goals that any new financial structure should satisfy:

- A sound and stable financial system
- The most competitive system consistent with soundness and stability
- Equal (or fair) treatment of all customers
- Protection for the small and unsophisticated depositor

While it is beyond the scope of this paper to describe all of the features of a new financial system, a number of potential facets of such a system deserve consideration.

1. Deposit insurance should be restricted to protecting only small depositors. It should not be so pervasive as to insulate depository institutions from the forces of market discipline. A broad-based deposit insurance system should be avoided because it entails an unmanageable moral hazard.

2. The chief protection against bank runs and other systemic risk should be the Federal Reserve. It should use its lender-of-last-resort capability to prevent systemic problems due to illiquidity.

3. Competition should be encouraged by the removal of barriers preventing competition. In particular, nationwide branching should be adopted and financial institutions should be permitted to undertake a wide range of financial activities, including securities activities.

4. The general antitrust laws should be applied to financial institutions to prevent monopolization and unfair competitive behavior and should constitute the only competitive standard applicable to financial markets.

5. Efforts should be made to impose greater market discipline on financial institutions. The adoption of market-value based accounting principles is a first step, along with the public disclosure of an institution's performance.

6. Regulation to protect the safety and soundness of the financial system should be backed primarily by minimum capital requirements and by a "closure policy" that closes institutions before they have zero or negative (market-value) net worth. Insolvent institutions should not be permitted to exist.

If these features were adopted as the centerpiece of a new system, it would be relatively simple to fill in the required additional elements.

Conclusion

This paper is a plea for action—an appeal to end the political paralysis that now immobilizes Congress and regulators. Twenty percent of all thrift institutions are now unprofitable, and more than 450 are already technically insolvent. It has been estimated that the FSLIC, which insures $900 billion in thrift deposits, is some $30 to $50 billion in the red, and every day it does nothing taxpayers potentially lose another $10 million.

The banking situation is also deteriorating. About 200 banks are expected to fail in 1987, and the FDIC's list of problem banks has soared to 1,600, up from 218 in 1980. Intense competition from both bank and nonbank sources, and depressed conditions in certain economic sectors, such as energy and agriculture, threaten an even greater number. Large banks, finally, are faced with a steady erosion of earnings over future years by having to write off an increasing amount of the $300 billion owed to them by third-world debtor countries. The ability of even the FDIC to meet its potential future obligations is by no means assured.

If nothing is done, the situation will continue to worsen. At some point, public confidence in our financial structure will collapse with potentially devastating effects. To do nothing is to challenge fate. Such a course is politically and economically irresponsible.

There are a number of long-standing myths about what are essential characteristics or components of a sound financial structure that must be debunked before we can hope to reform our financial system. These are, as you would expect, time-honored postulates, but ones that nevertheless must be confronted before we can move forward. By focusing debate on these general concepts, we can avoid much of the myopic political infighting that unfortunately dominates all discussions of financial reform. This paper sets forth a number of mythical postulates that I regard as serious obstacles to reform. My intention, clearly, is to center debate on these longer-run principles rather than on more obvious turf-threatening conflicts.

A companion effort must also be made to agree on and to adopt general goals for regulation. These goals are often lost sight of in our effort to respond to current exigencies and to shore up troubled institutions. Without having them to guide us, however, we are like a sailor without a compass: doomed to tacking back and forth aimlessly with only the slightest hope of finding the safety of solid land. I sketch out a number of general goals that I believe must guide our restructuring of the financial system.

In the coming months and years, Congress, regulators, and even the courts will be called upon to make decisions that will have far-reaching implications for the financial system and our economy. They must begin to develop a general blueprint to guide their way. Through debate, research, and discussion, such a blueprint can hopefully to be fleshed out to form a core of principles to guide us in creating a long-lasting, efficient, and sound financial structure.