Commentary on "Regulatory Policies and Financial Stability"

William Peter Cooke

Bob Eisenbeis' paper raises a host of issues of particular interest to the banking supervisor. However, I can only pick a few plums out of the pie. I will try to bring to my comments—as I understand I am expected to do—something of the perspective of the overseas observer looking in. Indeed, if I do not treat many of the issues that he raises with the seriousness and depth they deserve, or appear to ignore them, it is partly because George Benston has already covered a number of them. It is also partly because I have assumed my task is rather to give a detached, but I hope not too detached, international view of the major issues. I am troubled, though, by the extent of agreement among my academic colleagues and hope I am not failing the audience by not testing these areas of agreement more closely. I also offer no apologies for speaking as a working regulator in a group that contains—particularly on the platform yesterday and today—many academics. I find myself often coming out with a perhaps undesirably woolly, but perhaps desirably pragmatic, approach to problems that others are trying to grapple with in absolutes.

I have little difficulty in accepting the principal conclusion of the paper that deregulation has been only a minor cause of the principal problems experienced by the U.S. financial system. Compared, for example, with the impact of macroeconomic forces—whether oil or real estate prices or the problems of the agricultural sector—it seems to me that the consequences of deregulation, both in your country and mine, have been of lesser moment. Disentangling the various factors involved is, of course, always difficult, but I would suggest that deregulation has not of itself made the financial system more vulnerable to shocks. Rather, it ,may have exacerbated the effects of particular financial and economic developments on the system. It may be that these developments may themselves have produced pressures for deregulation; the existing regulatory arrangements prove unable to cope and some deregulation is introduced to allow the financial system to continue functioning effectively. A tightly regulated system is most likely to work effectively in a stable, unturbulent financial environment. Change induces pressures that tend to undermine the effectiveness of much regulation and requires its review.

It is a question how much of recent moves under the umbrella heading of deregulation have been an active or a passive process as far as the authorities are concerned. From a look at the structure of the U.S. financial scene, apparently well ordered with, for example, its Glass Steagall division and at least some remaining laws that constrain interstate activity, the surprising thing is how much is changing not as a consequence of the deliberate act of the authorities to move goalposts but rather as a consequence of the marketplace finding ways of spilling over the bamers that still exist. There will always be, however, a difficult question for the authorities of how far change can or should be resisted. We have been wrestling much with this question in London in recent months. In general, we have taken the view that, in the present state of markets, it is right for U.K. authorities to be positively removing barriers in order to assist what was felt to be a desirable process of change, particularly in the area of rapidly changing relationships between banking and securities markets. But it is always easier to make simple changes to simple structures; changing complex systems is often more difficult, and the consequences of change may be less easy to predict.

One question I found myself asking when reading Bob Eisenbeis' paper, but which I did not find an answer to in the paper, is, what exactly is that financial stability which is thought to be desirable? If I had to be pressed to define it, I would describe financial stability as an environment in which the market can operate with confidence but not with license. Stability in a financial system should not be equated with absence of change. Furthermore, and very importantly, stability cannot be separated from confidence. Confidence in the system is an essential ingredient of stability—people need to believe in the system to have confidence that it works. The problem is, confidence cannot be relied on to operate rationally. It may impact in different ways, at different times, and in different places. Confidence in the banking system may be maintained even when bank failures occur regularly—as might well be said to be the case, par excellence, in the United States at present. But confidence may also suffer when the system appear unreceptive to change.

It is also I think a *sine* qua non of financial regulation—like other constraints on the activities of individuals and corporations—that it will have behavioral consequences that cannot always be predicted. The decisions and behavior of the institutions subject to financial regulation will be affected in ways intended and in ways that are unintended, both on the directly regulated institutions and those not so regulated. The paper makes this clear in describing the innovative moves that are often the direct response to regulation. One frequent unintended consequence is a reduction in the competitiveness of the regulated institutions and an increase in the incentive for those escaping regulation to undermine the purpose of the regulation. This seems to be an important factor currently at work in the United States, and the process is all too familiar to us in the United Kingdom—for example, in the events leading up to the secondary banking crisis in the early 1970s.

,Now, there are two particular issues relevant to public policy on which I would like to concentrate a few remarks. First the trend toward "decompartmentalization" in the financial sector, particularly the move to financial conglomerates, and second, the problems in an increasingly global financial marketplace of handling the interaction of national regulatory policies and achieving a measure of coordination of them internationally. Both issues seem to carry at least the seeds of future instability if not handled effectively.

The first of these trends is particularly manifest in the development of the new multifaceted financial service conglomerates—a development for the moment most strongly evident in the United States and the United Kingdom. Certainly, as we see it in London, this phenomenon may well lead to confusion on the part of the authorities, the general public, and the institutions themselves about the interconnection of the different activities, the extent to which they are or are not controlled by the authorities and are or are not likely to be supported if they get into difficulties. This brings us back to confidence again. In London, we feel this is a particularly difficult current and potential problem as far as the traditional banking sector is concerned. How far can or should bank deposits finance other than mainstream banking activities? Is is sufficient to create separately capitalized corporate entities to undertake different financial businesses? How far does a bank have to stand behind its related financial (or, if permitted, nonfmancial) companies in a complex mutlifaceted group? Is the very nature of banking changing and will it be possible effectively to identify and deal with a traditional banking sector separately? And at the end of the day, importantly for the stability of the system, how far—if at all—in this new world is the central bank's responsibility expected to extend beyond the traditional banking sector in the discount window function or in the provision of lender of last resort support? How much more do these national problems become exacerbated when the matrix is extended to international groups of this kind?

I confess I do not have the answers to all these questions, but we need to make a stab at some of them soon in constructing the regulatory framework appropriate to this new situation. I have some doubts, however, at least outside the United States, of the merits of the concept outlined by Henry Kaufman yesterday of a "compendium" agency. There is certainly scope for regulatory mistakes in this new environment—perhaps big ones—but I am not sure that they would be less with one financial regulator. Where can such a polymath be found, I wonder? It would seem to me the organization would be extremely complex. And I wonder if such an inevitably ponderous organization could meet another of Henry's imperatives—a capacity to "act with alacrity?" In London, we are working on the assumption that there will be several regulatory bodies interacting and cooperating closely, but to try and bring them together in one super agency seems to me too ambitious and could be counterproductive. It is quite right, however, that the regulation of securities and banking businesses in particular are going to have to be closely coordinated.

Turning now to the globalization of markets. It is a truism that over the past decade or so national markets have all become part of one single global market. All national authorities are increasingly having to take account of this in devising and implementing national regulatory systems. I believe we are really only beginning to grasp the implications of this phenomenon for national regulation.

From the U.S. point of view, one might have thought that the predominance of the U.S. dollar as the main international means of payment and store of value would mean that U.S. authorities could ignore this global factor. Not so, I think. It becomes even more important for them than for many others just because the dollar is so internationalized. I sometimes think that many looking at the U.S.

financial scene tend to overlook the influence of international factors.

The U.S. authorities, no less than many others, cannot conduct domestic financial regulatory policy without taking account of the international dimension. This is frequently acknowledged in the public statements of the authorities. So the exposure of the U.S. banking system to problem debtor countries is a problem in the minds of many countries outside the United States and those countries' responses to the debt situation need to be taken into account in the stance U.S. authorities take. I worry, for example, about the divergence of the banks' response to their involvement in problem international lending in Europe, where on the whole they resort to rigorous and extensive provisioning or writedowns against problem country debt, and in the United States, where the response has been largely to build up general capital levels. These kinds of different approaches already—and may still more in the future—make for troublesome differences of perception and responses to the overall problem not conducive to stability. It also needs to be borne in mind that one consequence of the U.S. external deficits in recent years has meant that increasingly the funding of U.S. banks, particularly overseas, is undertaken by non-U.S. owners of dollar balances—another factor contributing to a global view of the market.

The potential for strains, fragility, or instability in international markets caused by this intertwining process requires that the problems be addressed increasingly at the international level. But how? There is no authority that can be wielded to deliver answers to the whole range of problems, assuming answers can be found. Effective international action—coordinated international action—has to rely on persuasion or more often a general perception of self-interest. Global acceptance of the need to improve capital adequacy levels is a good example of a positive and coordinated response—one, I may say, that was set in train before the Mexican crisis broke by the regulators in Basle made possible because many international authorities chose to follow a common path. We do what we can in Basle to identify trends internationally and to commend sound and homogeneous, if not necessarily identical, responses from national authorities. But the regulators meeting there cannot deliver. No international law can be invoked. Results depend on the goodwill and positive follow-up by national authorities.

This brings me to another suggestion of Henry Kaufman's yesterday when he advocated a new international body to exercise authority in finding solutions to international debt problems. I must say, it is not clear to me how such a body would acquire or be invested with the necessary authority to require action of national authorities. Of course, such a capacity would in many ways be desirable—just as it would for the far more important integration of the monetary, interest rate, exchange rate, and general economic policies of major countries. But I wonder if in practice it will be possible to move far from where we are at present where regulatory matters are debated closely and, certainly in the context of the regulators meeting in Basle, solutions are proposed for national authorities to consider sympathetically. This is, nevertheless, a major issue. Credibility and confidence in regulation—and I come back to confidence again—is important in sustaining stability. To take a topical example, a good deal of work is being done on the problems of banks' off balance sheet exposure. In this area (as well as others) the cry of "level playing fields" and consistency of regulatory approach is heard more and more often. We may be coming to a point where the international cooperation of the past ten years will be put to the test. The marketplace is asking for, and half expecting, some coordinated and consistent regulatory response in different countries to this growing feature of international banking business. Will it be possible to deliver, and how far will countries be prepared to modify their own systems and sometimes swallow long-hallowed prejudices to produce convergence in regulatory approaches? How will the market react if this is not achieved?

Now in addressing these two particular issues—and I raise them because I think they will become major regulatory policy issues in the period ahead—I have drifted away from the issues raised in the main paper for this session. Let me try to cover some of these briefly.

Bob Eisenbeis' paper touches on another important area of potential fragility in an integrated international system. This is in the technologically complex and technologically dependent systems for effecting payments within the financial sector. The nature of the problems and dangers are well known and I do not need to elaborate them here. I would make one general comment, however. There are, of course, dangers in concentrating the operational heart of the system in one place. But it is not all'bad. Tom Lehrer said a long time ago, "We'll all go together when we go." But in a perverse way, I believe such concentration can be a source of strength. Just because everyone depends on the system and everyone would suffer from its breakdown, there is induced a community of interest that operates to ensure that the worst never happens. There may be some high risks in relying totally on this assumption, but in practice mutual self-interest operates as a powerful adhesive. More Bank of New York-type problems, while of course undesirable and potentially very troublesome were they to occur, might not in fact prove a total shock to the system. Banks may well be prepared to muddle along until the technological problems are sorted out. This is not to brush aside what could well be a real headache for the authorities, but I do think we can derive some comfort from the fact that the last few years have demonstrated that there is a great deal of robustness in the international banking system. The debt crisis of 1982 and thereafter, for example, have been managed in a way that those of us who sat in Toronto wondering where and when lightning would strike next could hardly have dared hope. The cohesive forces at work that have helped to make this possible will I believe continue to be a powerful influence.

Now I suppose no comment on the U.S. financial scene would be complete without some reference—and I confess to being surprised not to find the phrase anywhere in the Eisenbeis paper—to the issue of moral hazard. An important part of the regulators job is balancing the stick and carrot for individual institutions and balancing the risk to the system against allowing individual failures. The paper treats the related subjects of deposit insurance, lender of last resort, and bank failures provocatively and in doing so puts forward a number of interesting ideas. I would though take issue with some of the proposals that are put forward.

First, deposit insurance. The paper argues that pricing reform is needed and, in particular, that market-based methods to enhance market discipline, involving the introduction of a risk-based premium system, should be introduced. I understand and sympathize with the desire to improve discipline when safety nets seem to make life too comfortable, but I have always had doubts that this is the best way to achieve it. It seems to me to duplicate the role of capital as a means of containing a bank's risk taking. But then I come from a country that, with others in Europe, relies on a measure of capital adequacy that is related to the risks in the balance sheet (and off it). If the U.S. authorities are moving toward a similar system, risk-based premiums should be unnecessary; capital requirements should already take account of the risks for creditors of different banks' business. In such circumstances, a risk-based insurance premium would look to me like double taxation—and fiendishly difficult to administer. In the United Kingdom at least, we see deposit protection as having the limited role of providing a significant but not comprehensive protection for the small personal depositor. Under this approach, depositors and investors are expected to accept some responsibility for addressing the safety of their savings and should be made aware that depositing with a bank involves an element of risk. That is why the U.K. system places a limit on the size of a protected deposit (only up to the equivalent of some U.S. $15,000) and limits protection to three quarters of that sum. The larger investor, and especially the professional, is expected to carry out his own risk assessment and diversify his exposure. This seems a better approach to injecting market discipline. But then I would say that, wouldn't I, and I do not wish in any way to undervalue the importance of the insurance schemes of the FDIC's and other federal agencies' schemes in holding what might otherwise be a somewhat fragile situation currently.

The paper also proposes a closure policy for failed institutions. Unless I have misunderstood the argument, this policy would require banks to be closed "when the market value of their net worth goes to zero" because it is only by doing so that the imposition of costs on uninsured creditors can be avoided. This rule would also avoid perverse incentives that increase the risk exposure and potential losses for the insurance fund. Again, it is suggested that it is only by such a rule that market discipline and its desirable incentive effects can be ensured. I cannot fault the tidiness of the concept but I doubt its applicability. The range of issues that the authorities have to weigh do not in my view allow such simplistic solutions. In practice, the difficulty of valuing a bank's assets, and the often marked difference between the value of a bank's assets on a going-concern and on a break-up basis, would mean that, to avoid all possibility of loss to creditors, banks that are marginally solvent would also need to be closed down. Sudden events, too, may occasionally cause insolvency, but even in those cases, the exact point when a bank becomes insolvent is, in my experience, impossible to determine. In practice also, such a policy could lead to higher losses for depositors than a more flexible approach. Finally, the paper seems to me to pass rather too lightly over the systemic consequences of liquidating a significant bank.

This latter point leads me to the paper's comments concerning the lender of last resort function. You will not be surprised to hear a central banker say that the authorities must reserve their judgment to keep afloat, in the paper's terminology, "market value insolvent institutions." The central bankers view of this in my experience is invariably: no hard and fast rules; consider each case as it comes along in the light of the circumstances at the time. The idea that it will in all circumstances be possible to act to make "the likely failure of a large bank an isolated event" does not seem to accord with experience, although, of course, it has to be said it has not often been put to the test.

I am also not sure about the argument that, to enhance market discipline, discount window borrowing should only be done at penalty rates. This may be reasonable in day to day lender of last resort operations, when penalty rates are often applied in many countries. But for problem bank situations, it does not seem so attractive, or necessarily desirable. If a bank requires assistance because of a perhaps vicarious lack of market confidence, a penal rate would not appear justified. If a bank is near insolvency, applying penal rates may merely force it into liquidation. Adequate and attentive ongoing supervision should be the principal means of ensuring that risk taking by banks is properly controlled. It is too late to worry about incentive effects when the bank is seeking help from the authorities. The supervisor's objectives, I believe, should be principally preventive rather than punitive. Punishment is often merely a sign of failure and often counterproductive to boot.

The author's inherent caution will probably mean that rescues take place more often than some purists might desire. This is not to say, however, that a bank's managers or shareholders should escape all the consequences of failure. It is only right that bad and reckless management should be replaced and sleepy shareholders should lose their equity, but forcing **all** technically insolvent banks into liquidation would seem to me excessive. Inevitably, size will be a determinant of decisions whether to rescue or not, but it continues to be important, in my view, that the authorities make clear that it should not be assumed that they will stand behind a bank just because it is large.

Now just a very brief and, therefore, an all too inadequate word on problem international debt. In considering the banks' exposure to problem country debt, the paper again takes a somewhat purist line and seemingly would require banks to write off problem country debt, and desist from new lending. The international debt problem, I do not need to say, is difficult and complex and, as with bank rescues, involves important systemic issues. I will eschew simplistic statements about the justification for increased lending to problem debtors. Suffice it to say that I believe such lending can be justified on systemic grounds and from the point of view of the interests of individual banks. This is not to say, however, that the judgments are not often difficult and finely balanced, and the problem of keeping everyone pointing in the same direction more and more difficult. The trouble is, much international debt is in the wrong form. The banks are not natural providers of the kind of financing the Third World needs. Reverting to another issue mentioned earlier in this meeting, I wonder if some way may not be needed of injecting some more direct element of public financing into the rolling process of adjustment as international markets and countries work toward a better equilibrium over time.

In all of this, the critical question seems to me to be the manner of the supervisor's response to the world as he observes it. He needs to be alive to the consequences of the actions of other regulators abroad and those of different but related disciplines at home. He needs to be continually on his toes, responding in timely fashion to change and trends both in markets and, very importantly, in the macroeconomic environment. This year and last year, the push has been for capital adequacy. This year and next, it will be the capturing of off-balance sheet business. Perhaps looking ahead, liquidity strains may appear, as a consequence in part of regulatory pressures on capital, and require the supervisor's attention. Alternatively, if the international environment becomes recessionary, profit levels could start to look rather sick.

But please recognize the limits of what the regulator can achieve on his own. He has his particular corner to fight and should do so. But he should never fight blindly in the face of the realities in the world around him. Judgment and flexibility should be key elements of his armory, without, I would hope, the compromising of basic supervisory imperatives. As I said at the outset, far more instability and problems for the financial sector derive from changes in the macroeconomic environment than through imperfect regulatory rules and practices.

"We are," as a former Governor of the Bank of England remarked "where we are" in the context of the international debt problems a few years ago. We are still there. Grand designs are for the birds. The situation has to be handled as it is. In this respect, I agree very much with what Rimmer de Vries was saying yesterday. We do not have the luxury of the Irishman saying, when asked the way to Tipperary, "Oh if I were going there, I wouldn't start from here." Thoughts of perfection anyway is a reverie that financial regulators cannot allow themselves to be seduced by.

Markets and institutions wax and wane. Regulation needs to keep abreast of change. We are now perhaps in a deregulatory mode. Certainly in London it has been a deliberate policy to give the market its head—a high-risk strategy that of necessity carries with it a warning of pain and tears to come and a willingness to see market discipline operate. Perhaps in a few years, or even sooner, some re-regulation will be considered necessary to bed down a market that has settled into a new environment.

But in this sometimes dangerous, always difficult, world, prudential regulators, alive to events and fleet of foot, still in my view hold one of the most important keys to sustaining financial stability. They must set a sound framework with relevant prudential parameters for individual institutions and the financial system that allows them to play their proper role in the economy. But they cannot and should not, and should not be expected to, set out to cover every exogenous pressure in advance.