

REGULATORY RESTRUCTURING: RESOLVING THE FED'S CONFLICTING ROLES

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Regulatory restructuring has surfaced again in political and academic debates in and around Washington. This is not a new topic. Proposals for a more efficient, a more responsive, or just a different regulatory system have been around at least since the late 1930s. The most recent restructuring proposal was offered by the Clinton administration in March 1994. As of April 1994, this proposal seems to be stalled in Congress in large part because of opposition from the Federal Reserve System.

Most restructuring proposals are motivated by the desire to streamline or consolidate the bank regulatory structure.¹ The Clinton administration's proposal is offered as part of its initiative to reinvent government, for example. Others support regulatory restructuring because of the perceived need to address inequities in cases where institutions offering similar services are regulated differently. My interest in the topic has grown from other concerns. First, regulatory restructuring could be a path to creating a regulatory system that is more responsive to changing market conditions. Second, regulatory restructuring could establish the basis for demonstrating the superiority of financial systems marked by less government involvement. Finally, regulatory restructuring could offer a means for dealing with the increasing role forbearance and the "too big to fail" doctrine have played in bank regulatory policies.

Whatever the reasons for considering regulatory restructuring, it also provides a useful context within which to discuss the various roles of the Federal Reserve System. The Fed is not only the nation's

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¹In this paper, "banks" and "banking" refer to depository institutions generally unless noted otherwise.

central bank, it is also the lender of last resort and a bank regulator, and it competes with banks in providing certain services. Many authors have argued that these multiple roles create conflicts of interest. Other observers contend that the Fed must wear many hats to be effective.

The purpose of this paper is thus twofold. First, I suggest a regulatory restructuring plan designed to enhance the advantages of the dual banking system while addressing some of its shortcomings. Then I focus on the role the Federal Reserve should play in a newly structured regulatory system.

My own preference is definitely for less regulation rather than more. In England (1988), I argued that we would be better off today if federal deposit insurance had never been introduced. I am convinced by arguments from George Selgin (1988), Larry White (1989), and Kevin Dowd (1992), for example, that closing the central bank and eliminating industry-specific regulation would lead to a more responsive, more stable financial sector. But as Lee Hoskins (1991: 3) noted:

It is not sufficient to argue that market-oriented alternatives to our current central banking structures function better in other times and places. . . . This begs the question of why such a system did not prove to be sustainable. Nor is it sufficient to argue that this system would have prevailed if not for government intervention and interference. This line of debate fails to consider whether any political equilibrium exists that would support a market-oriented system in a modern economy.

I assume then that we will continue to have a central bank and government regulation of banking for the foreseeable future. Given those constraints, I focus on the type of regulatory system that would lead to a stable financial sector positioned to support economic growth.

Problems with the Current System

There is fairly widespread agreement about the fundamental shortcomings of the current system. Several sources have outlined the problems with the existing structure. Bernard Shull's (1993: 100) list is typical.

First, there are unnecessary costs created by overlapping responsibility and duplicate effort. A commercial bank may be subject to examination by as many as three different federal or state regulators. Despite the fact that regulators have attempted to divide oversight responsibilities to minimize overlap, it is clearly more costly to maintain several separate federal regulatory agencies than it would be to maintain one agency.

Second, institutions offering similar services may face different regulatory burdens. This is true within the commercial banking industry,

but it has become even more of a concern as the distinctions between the banking and thrift industries have been blurred. For equity's sake, it is argued, firms offering similar services should be regulated similarly.

Third, multiple regulatory agencies may lead to competition among regulators. This competition for control over depository institutions is often viewed negatively, and it is expected to lead to a "race to the bottom."

Fourth, the existence of multiple agencies may make it difficult for supervisors to coordinate regulatory efforts when they need to do so. The information necessary to get a "complete picture" of the health of a single large bank holding company may be scattered among several agencies. A bank holding company that owns thrifts, nationally-chartered banks, and state-chartered institutions may have its components examined by as many as four different federal supervisors as well as several state regulators.² Institutional differences may make it difficult for regulators to work cooperatively on common problems.

Finally, overlapping responsibility may lead to inadequate accountability. When several regulators are responsible for supervising all or part of a depository institution, it is easier to blame someone else for problems that arise.³

Many regulatory reform proposals focus on the first and third concerns identified by Shull. These proposals call for consolidating bank regulatory responsibility as a means of reducing regulatory costs and limiting competition among regulators. As a rule, those who see no need for the Fed to continue in a supervisory role favor one federal agency while those who believe that the Fed should continue to regulate some banks or bank holding companies would have two regulatory bodies.⁴ Interestingly, in early discussions of bank regulatory restructuring, the Clinton administration's spokesman, Treasury Secretary Lloyd Bentsen (1993: A21), saw no reason for the Fed to continue as a bank regulator. By March, Jerry Knight (1994: F3)

²Passage of legislation allowing interstate branching addresses this concern to some extent. A multistate bank holding company that owns both state- and nationally chartered banks will be asked to choose the charter under which it will operate when converting to a single bank with widespread branches. Thus, there will be one primary regulator for the entire banking organization.

³The Treasury's (1991) report also argues that more consolidated regulatory responsibility would make it easier for U.S. officials to coordinate regulatory standards here with those being used in other countries. Because I believe there are advantages to competing regulators, I would argue against making it easier for international bodies to coordinate regulation across national boundaries.

⁴In the former group see for example, George Benston (1983) and Paul Horvitz (1983). Shull (1993) is representative of the latter group.

reported that the administration's suggested reform retained a role for the Federal Reserve in overseeing banks' activities.

In evaluating restructuring proposals, it is important first to distinguish between two types of regulatory costs: the costs to the federal government of operating the agencies and the costs of regulation borne by regulated institutions (and hence the economy). Current restructuring proposals focus on the former rather than the latter. I would suggest that without competition among the regulatory agencies, the latter costs would have been higher than they are. My focus is on the fourth and fifth problems identified by Shull—the need to reduce the regulatory burden by allowing a banking organization to answer to a single regulator and the need to improve accountability among regulators.

A Restructuring Proposal

As long as the government guarantees banks' liabilities, the government must assume some responsibility for supervising banks' operations. There are two broad types of risks associated with bank supervision. On the one hand, regulators might be too lax, allowing private decisionmakers to operate depository institutions with no private capital at risk, for example. On the other hand, supervisors might be too rigid and inflexible. Overly strict regulation that prevents depository institutions from adapting to changing market conditions may be just as dangerous as inadequate supervision.⁵ Washington policymakers tend to focus on the first type of risk and ignore the second. A healthy, stable financial sector requires a balance between the risk associated with stagnation and the risk associated with new, untried activities. It is the attempt to balance that tradeoff that drives the specifics of the proposal outlined below.

Competing Supervisory Agencies

The ability of banks to choose among different supervisors can provide an important protection against overly rigid regulation. The dual banking system served the country well as long as there were real differences between the regulation of nationally-chartered and state-chartered banks.⁶ In restructuring the regulatory system, I suggest

⁵As a case study in both types of regulatory risk, consider the savings and loan industry. Overly strict regulation got the industry into trouble in the late 1970s, then inattention to the resulting insolvencies made problems worse in the 1980s.

⁶With the introduction of federal deposit insurance, the distinctions between federal and state banking supervision began to disappear (see Butler and Macey 1988). This is not surprising given the federal government assumed the responsibilities associated with deposit insurance. I will return to this issue below.

we create three autonomous supervisory agencies or groups of agencies.

First, at the federal level the regulatory responsibilities of the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC) would be combined into a single independent Federal Banking Administration (FBA). This agency would supervise banks and savings and loan associations choosing to operate under a national (or federal) charter.

The second group of regulators would be the state banking authorities. The new interstate branching law will make state-chartered multi-state banks subject to regulation by the chartering state (i.e., the state where the bank's headquarters are located).⁷ The chartering state will be responsible for overseeing the financial health of the entire banking organization, regardless of where its branches were located.⁸ This is similar to the way in which insurance companies are regulated, and an organization such as the Conference of State Bank Supervisors might assume a coordination role similar to that of the National Association of Insurance Commissioners.⁹

A third regulatory organization might be made up of the regional Federal Reserve Banks separated from the Federal Reserve Board. The regional Federal Reserve Banks might even be made a third possible source of charters. The bank examiners and the payment system expertise are at the regional banks, and in this proposal, the Fed's sole focus would be on conducting monetary policy, thus eliminating the need for the current regional banking structure.¹⁰ It is tempting to suggest that the regional Federal Reserve Banks, cut loose from the Federal Reserve Board, would behave like private self-regulatory organizations in their supervision of depository institutions. The regional reserve banks are "owned" by their member institutions,

⁷Under the current system, state-chartered banks are also subject to a federal regulator—either the Federal Reserve System (for member banks) or the FDIC (for nonmember, federally-insured banks). My proposal would eliminate this federal overseer of state-chartered banks.

⁸Branches in "host" states (states other than the chartering states) will still be subject to state consumer protection laws.

⁹State regulation of the insurance industry has shortcomings, but the state-regulated insurance industry suffered from fewer failures during the 1980s than the federally-regulated banking and savings and loan industries.

¹⁰Input from the regional bank presidents might be missed at the Federal Open Market Committee meetings. But having regional input for the FOMC would hardly seem to justify the current system if the Fed were stripped of its regulatory, discount window, and payment system functions. A requirement that governors of the Federal Reserve represent different regions might be substituted for the current system.

after all. Their ultimate behavior would no doubt depend on the incentives created by the legislation separating the regional banks from the Federal Reserve Board.

Each supervisory agency would maintain its own deposit insurance fund. The funds would be "pre-capitalized" by dividing the assets of the FDIC (both the Bank Insurance Fund and the Savings Association Insurance Fund) on a pro-rata basis depending on the number and size of depository institutions choosing a particular regulator. To overcome the problems created by inadequate diversification, the state banking authorities might operate a single insurance fund for all state-chartered banks. Similarly, the regional Federal Reserve Banks might operate a single insurance fund. Institutions supervised by a particular agency or group of agencies would be assessed the premiums necessary to keep their fund at a specified level of deposits.

Once the bank supervisors were established, each bank would decide to what supervisory agency it would answer.¹¹ Bank holding companies that decided not to convert to a single, branched bank would still be required to choose one supervisory agency to oversee both the holding company and all subsidiary depositories. There would thus be one regulator for each banking organization, broadly defined. This would help increase regulatory accountability and reduce the information and coordination costs associated with multiple regulatory agencies.

Banks would choose their regulators based on the regulatory package they offered. Under this proposal, Congress would give broad discretion over regulatory issues to competing supervisors. Each of the independent regulators would establish its own capital requirements, reserve requirements, powers restrictions, and branching and merger guidelines, for example. It is on the basis of these regulatory packages that agencies would compete.

It is easy to imagine a number of possible tradeoffs. One agency might set relatively high capital standards but allow banks to offer a broad range of products and services. Another agency with lower capital requirements might employ more powers restrictions. One agency might require market value accounting while another employed book value standards. The handling of bank failures could vary from regulator to regulator. Finally, one agency might charge risk-based deposit insurance premiums while another agency would not. The basis for preventing this competition from becoming the

¹¹Banks would display prominently their choice of supervisor. Some depositors might choose their banks on the basis of who regulates them.

widely feared race to the bottom would be the deposit insurance arrangements.

There is some debate about the desirability of combining the regulator and the insurer. Thomas Cargill and Thomas Mayer (1992: 96-97) observed that, "Bank regulators, for their own preservation, possess a bias toward expanded bank powers in an environment of declining bank markets." The Treasury Department (1991: XIX-5) viewed that regulatory bias as a source of conflict between the regulatory and insurance functions. Regulators are concerned with promoting the industry's long-term market share, while insurers have a shorter-term focus, bent on protecting the insurance fund.

I believe the tradeoffs inherent in the tension between promotion and insurance can best be harnessed within one agency.¹² By requiring that banks supervised by a particular agency also assume responsibility for the costs of failures of other institutions supervised by the same regulator, bankers would be encouraged to help monitor both their competitors and the activities of their regulator. The least-cost regulatory package would be one that promoted stability among member banks.¹³ Banks would benefit from efficient, effective supervision, and bankers would have reason to complain about policies that increased losses to their deposit insurance fund.

Requiring periodic reports that measure the relative performance of competing supervisors would reinforce these incentives. Such reports might include information about the number of bank failures in recent years, the average capital level, or measures of profitability for institutions supervised by competing regulators. Bankers associated with more effective supervisors would thus gain reputational capital.

Finally, I would allow those institutions willing to forgo government guarantees of their deposits to opt out of industry-specific government regulation all together.¹⁴ Such institutions would be required to tell their customers that their liabilities were not insured by the government.

¹²The failures of the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation would seem to provide a rather dramatic example of the inability of a single agency to balance the tradeoffs inherent in regulation coupled with insurance. Remember, however, that the Bank Board's ability to adapt regulations to changing market conditions was constrained by Congress. The Bank Board suggested long before 1980 that federally-chartered S&Ls be allowed to offer adjustable rate mortgages, for example, and Congress refused.

¹³One problem created by the dual banking system was that state bank and thrift regulators could change restrictions on state-chartered banks knowing that any losses would be widely spread through the federal deposit insurance system (see Kane 1984: 768-69; and England 1990).

¹⁴Of all the long-shot suggestions contained in this paper, this is obviously the longest. But as I am making the suggestions, I might as well include my own favorite.

Uninsured banks would probably initially cater to fairly sophisticated customers who felt able to assess their bank's strength on their own.

The Advantages of Regulatory Competition

Competition is generally favored by economists and policymakers as a means of minimizing the cost to consumers of obtaining a particular good or service. Competition also encourages providers to pay continued attention to the quality of the services they offer. Better quality bank supervision at a lower overall cost would show up in the cost and quality of the services banks offer their own customers. Edward Kane (1991) likened international harmonization efforts among bank regulators to attempts by commercial competitors to establish a cartel. Life is easier for both government regulators and private businessmen when they face less competition. But as a rule, customers in both cases benefit from competitive forces.

Competing regulatory agencies with broad flexibility to adapt their rules to changing conditions would also offer the advantage of increased diversity and innovation in our approach to financial regulation. There is often no single right answer to questions about capital requirements, accounting standards, or powers restrictions, but a single approach applied to an entire industry may be the wrong answer as we saw in the case of the savings and loan associations. Policymakers would not be asked to "bet the industry" by choosing sides in the debate about whether commercial banks would be strengthened or weakened by allowing them to engage in investment banking activities, for example. A more flexible, competitive regulator might allow some or all of its banks to engage in such activities, providing empirical evidence about the impact of allowing banks broader powers. More diversity would protect private financial institutions and the economy from the consequences of regulatory mistakes as well as allowing for the discovery of better ways of supervising financial institutions.

The Role of the Fed

Anna Schwartz (1988) established that across time and across countries, a key ingredient in banking instability has been price instability. She then concluded (1988: 54–55) that:

The critical condition that will determine the safety and soundness of financial institutions in the future, as it has in the past, is the price level environment in which they operate. . . . Stabilizing the price level will do more for financial stability than reforming deposit insurance or reregulating.

Despite this, Alfred Broadus (1993) pointed out that the Federal Reserve has no clear mandate to pursue price-level stability.¹⁵ The Fed is asked to do many things, including lowering unemployment, regulating banks, and running the payment system, in addition to fighting inflation and deflation. I would argue that the central bank's sole focus should be on providing price stability as a necessary ingredient to broader economic stability. This proposal would thus relieve the Fed of its responsibilities in regulating banks, running the payment system, and operating the discount window.¹⁶

The Discount Window and Bank Supervision

The Federal Reserve System has vigorously and consistently defended its role as a bank regulatory agency and lender of last resort. Marvin Goodfriend and Robert King (1988: 231–32) quoted a 1985 Federal Reserve position paper:

Central banking responsibilities for financial stability are supported by discount window facilities—historically a key function of a central bank—through which the banking system, and in a crisis, the economy more generally, can be supported. But effective use of that critically important tool of crisis management is itself dependent on intimate familiarity with operations of banks, and to a degree other financial institutions, of the kind that can only be derived from continuing operational supervisory responsibilities.

The Clinton administration's proposal provided the most recent opportunity for the Fed to defend its position as a bank supervisor. Alan Greenspan (1993: A16) insisted that removing the Federal Reserve from "direct, hands-on involvement in supervision and regulation" would have "bad effects on public policy in a number of areas, most especially our ability to anticipate and cope with potential systemic financial problems."

Operation of the discount window was one of the primary reasons for creating the Federal Reserve. The Fed's first regulation, Regulation A, established the rules under which member banks could borrow funds from the Federal Reserve System. But solvent banks in need

¹⁵Broadus (1993: 6) noted that the Federal Reserve was not given a mandate to pursue price level stability in the beginning because, "The clear presumption underlying the Act was that the new central bank would concern itself mainly with making liquidity available on a timely basis to smooth short-term movements in interest rates." The United States was on the gold standard at the time, and the nation's money stock and its price level were governed by the nation's stock of gold.

¹⁶The version of this paper presented at the conference suggested the Fed continue operating the discount window. I have since been convinced that the discount window is unnecessary to conduct effective monetary policy, and its potential for abuse is not offset by possible benefits (see Goodfriend and King 1988; and Schwartz 1992).

of borrowed reserves today enjoy a number of choices they did not have in 1913. Further, Goodfriend and King (1988) have demonstrated that the discount window is not necessary to the Fed's conduct of monetary policy. Finally, more than 80 years experience with the Federal Reserve has proven how costly its operation of the discount window can be.

The Federal Reserve does not need the discount window to provide liquidity to the financial system. More neutral open market operations can accomplish that function. The discount window enables the Fed to direct assistance to individual institutions or groups of institutions. It is this use of the discount window to support specific institutions that has alarmed observers in recent years.

Schwartz (1992: 59) reported the results of an inquiry from the House Banking Committee. Between January 1, 1985 and May 10, 1991, 530 banks that borrowed from the Fed's discount window had failed within three years of the onset of their borrowing. Of these 530 failed institutions, 437 had been able to borrow from the Fed despite having been assigned the lowest supervisory rating—CAMEL 5.¹⁷ Sixty percent of these institutions had loans amounting to \$8.3 billion outstanding to the Fed at the time of their failure, and \$7.9 billion of this total was extended to institutions with CAMEL 5 ratings. In the face of this evidence, it is difficult to believe that the Federal Reserve remains committed to lending only to solvent banks.

The concerns generated by this type of discount window lending are many. In the first place, loans to insolvent institutions are in reality government-sponsored capital infusions. Such discount window advances allow insolvent banks to stay open longer than they otherwise would. The evidence is abundant that delaying a bank's closure generally leads to increased losses as owners and managers use the time to gamble to recoup past losses. Extended discount window loans to troubled institutions also facilitate the "escape" of uninsured depositors from these institutions. This not only increases the cost to the FDIC when the institution is finally closed, it also increases moral hazard by encouraging larger, more sophisticated depositors to seek high returns from unstable institutions in the expectation that they will be able to pull out before banks are closed. The belief that they will be able to borrow for extended periods from the Federal Reserve also encourages less caution and more risk-taking among bank managers.

¹⁷CAMEL is the acronym for the five measures of bank health considered by examiners: capital adequacy, asset quality, management, earnings, and liquidity. A CAMEL 1 institution is considered in good health while a CAMEL 5 institution is viewed as being in eminent danger of failing.

Further, when weak banks obtain subsidized discount window loans, they gain a competitive advantage over stronger institutions dependent on private debt and equity capital. This further skews incentives toward more risk-taking.

Finally, as long as the discount window remains open it will be subject to political pressures to use it to support favored borrowers. Although this pressure is most apparent where large banks are concerned, it does not end there. Schwartz (1992: 61) reported that from 1934 to 1946, the Federal Reserve Banks made some 3,500 loans amounting to more than \$560 million to nonbanking commercial firms "unable to obtain assistance from the usual sources." The Nixon administration urged the Federal Reserve to lend to the Penn Central Railroad in 1970, although the Fed rejected the request. In 1975, some congressmen suggested that the Fed might lend to New York City during its fiscal crisis. More recently, William Seidman asked Congress for a Federal Reserve loan for the FDIC in 1991, and Rep. Joseph Kennedy introduced legislation (H.R. 1257) in the 103rd Congress that would open the Federal Reserve's discount windows to the insurance industry. It is encouraging that the Federal Reserve has resisted the most recent requests to provide funds to nonbank institutions, but past resistance is no guarantee of continued success in the future. Closing the discount window would remove the temptation of Congress to use the Fed as a convenient source of off-budget credit.

In short, solvent banks in need of liquidity should be able to obtain funds from private sources. Improved information technologies, increased financial integration, and now the advent of interstate branching should eliminate the need for discount window loans for healthy institutions. No doubt if the Fed's discount window were closed these sources of funds would be strengthened and/or other sources developed. As Goodfriend and King (1988: 235) concluded:

As with many other areas of government intervention, the efficacy of discount window lending turns on the relative efficiency of the government and the private sector in undertaking a productive activity. We know of no analyses that document the relative advantage of the Federal Reserve in this area. Plausibly, the private market is superior because it is difficult for the government to lend only to illiquid but not insolvent banks, rather than succumbing to political pressure to support powerful banks.

Operation of the Payment System

The Fed was patterned in part on the more successful 19th-century clearinghouses. The need for a nationwide clearinghouse, or bankers' bank, grew from the fractured nature of the U.S. banking system, but

even so, it was 1980 before the Fed allowed nonmember banks to have direct access to its payment system.

There is no reason today for the Fed to run the payment system. There are certainly other models available. Angela Redish (1991) pointed out that the Bank of Canada is but one member of the separate Canadian Payments Association. There are also private clearinghouses in operation today.¹⁸ George White (1983) argued that these private organizations would make more efficient payment system choices without the overwhelming influence of the Fed. George Benston (1983) suggested that the Federal Reserve's payment system be reorganized as a private corporation, with member banks' stock in the Fed exchanged for stock in the private payment organization.

A Sampling of Objections

Gerald Corrigan (1991: 10) asserted bluntly that, "The Federal Reserve, as the nation's central bank, must maintain an important role in the bank supervisory process." There are at least three bases for this assertion. The first has to do with judging the solvency of those who apply for lender-of-last-resort assistance. Second, John Kareken (1984) concluded that the Fed is less effective at conducting monetary policy when it is required to put out the fires associated with large numbers of bank failures. In Kareken's view (1984: 429), the Fed's insistence that it must act as a regulator arises from a conviction that the OCC and the FDIC "cannot be expected or trusted to regulate with the objective of keeping the Federal Reserve from having to serve as lender of last resort." Finally, the act of supervising and examining banks is also said to provide the Fed with information about the health of the economy that aids in the conduct of monetary policy.

There are several responses to these arguments. I have already suggested that the Fed close the discount window. The Fed's willingness to lend to insolvent institutions for extended periods of time may, in fact, arise from the conflicts of interest created by the Fed's dual role as regulator and lender of last resort. Because bank failures are often viewed as regulatory shortcomings, the Fed is often on the side of hoping that troubled banks will recover. If they do not, the FDIC, not the Fed, picks up the tab.¹⁹ Furthermore, the other regulators

¹⁸Many of these private clearinghouses serve regional markets, and they often compete directly with Fedwire for business. The largest of these private systems is the Clearing House Interbank Payment System (CHIPS), operated by the New York Clearing House Association. CHIPS processes large international payments.

¹⁹The Federal Deposit Insurance Corporation Improvement Act of 1991 did take some steps to shift a small part of the cost of delayed closures back to the Fed.

may also have become dependent on the Fed's willingness to lend to keep troubled banks open. Regulators without the safety net of the discount window might do a better job of regulating from the beginning.

There are also potential conflicts in the Fed's role as regulator and central banker. Stricter capital standards set to go into effect in December 1992 were initially expected to cause a large number of bank failures. Instead, bank profits soared to record levels during 1992, allowing many weak institutions to avoid failure. Robert Vaughn and Edward Hill (1992: C3) observed that,

The improvement that occurred in bank stock prices—and the ease with which even relatively weak banks can raise new equity—is largely the result of the Fed's decision to lower reserve requirements, the FDIC's decision to bail out sick banks before they become truly insolvent, and falling interest rates which let banks cut their cost of funds even more rapidly than their loan rates. None of these changes the underlying problems facing weak banks.

The impact on the banking industry did raise questions about the Fed's motives in pushing down interest rates in the fall of 1992.²⁰

Paul Horvitz (1983: 259) also observed that because both monetary policy and financial regulation often involve political controversy, the Fed must often choose where to concentrate its political power to protect its autonomy. According to Horvitz, its desire to protect its independence in monetary matters has led the Fed to seek to avoid confrontations on "peripheral" issues, including regulatory issues. He thus concluded that, "It is not coincidental that the Federal Reserve has been the most conservative and least innovative of the federal banking agencies."

Finally, controlling the money supply does not require the Fed to regulate banks or set reserve requirements. It merely requires the Fed to know what reserve requirements are. Similarly, there is no reason that the Fed should not have access to any data it wants from the bank supervisors. The German Bundesbank does not regulate banks, it only conducts monetary policy, but banks regularly provide information to the central banker about economic conditions.

In short, Corrigan (1991: 11) got it backwards when he stated, "The stability of the financial system is a prerequisite not only to the conduct of monetary policy but also to the very goals of price stability and economic stability." Price stability and economic stability following from the proper conduct of monetary policy are, instead, prerequisites for the stability of the financial system. As the central bank, the Fed

²⁰See Jerry Knight (1992) or "A Central Bankers' Charter," *Economist*, 10 October 1992.

should create the first line of defense against widespread bank failures by conducting appropriate monetary policy.

Conclusion

There are clearly problems with the current regulatory structure. The system is awkward and often redundant, and it frequently raises questions about who is in charge. Making matters worse, bank failures reached post-war records over the past decade. Current debates first focus on systemic risk and then on how banks and S&Ls should be allowed to adapt to changing market conditions. Meanwhile, progress on the policy front seems slow. It may be that regulatory restructuring can provide a way out of this maze.

Competing regulatory agencies with broad flexibility to adapt their rules to changing conditions would offer the advantage of increased diversity and innovation in financial regulation. A regulator whose policies led to excessive bank failures would lose market share. Meanwhile, private banking institutions would have an alternative when they disagreed strongly with the policies of their supervisor. The ability to opt out of the system altogether would further enhance the choices facing both banks and the economy.

It is also time to reexamine the role of the Fed in the bank regulatory process. The Fed's most important contribution to financial stability is proper conduct of monetary policy. By removing the Fed from bank supervision and by closing the discount window, the Fed would be freed to focus its attention on monetary policy. The Fed has protested that its role in bank supervision is essential to avoiding systemic risk. Schwartz (1992: 66) concluded that:

If fear of contagion is a lesson the Federal Reserve has learned from the banking panics of 1930–33, it is the wrong lesson. Contagion then occurred in an environment in which the Fed permitted the money supply to decline drastically, rendering banks insolvent not because of their own actions but simply because of the collapsing economy. The right lesson is that contagion need not arise if open market purchases are made adequate both to reassure the market and to prevent a collapse in the quantity of money.

Clarifying the Fed's role is thus the most important contribution to future bank stability.

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THE FED'S DUAL ROLE AND REGULATORY RESTRUCTURING

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Catherine England's paper proposes an alternative model of bank regulatory responsibilities, but it is not clear from the paper what is broken that needs to be fixed or that the proposed solutions address whatever is broken. Moreover, the paper does not go into detail about the Federal Reserve's role as a provider of payments services, although considerable concern has been expressed from time to time about the potential conflict between this role and its role as a bank regulator. Thus, rather than focusing narrowly on England's paper, let me make several general points that I believe are germane to the discussion.

A Competitive Provider of Payment Services

The first point I would like to make is that, since 1980, the Fed has had to meet a market test in order to remain in various payment services, and it has done so. As a consequence of the Monetary Control Act of 1980, the Federal Reserve provides payments services—check processing, electronic funds transfer, automated clearinghouse, and cash and securities services—with the obligation that costs are covered by revenues, where costs include the “private sector adjustment factor” (PSAF). By definition, the PSAF includes estimates of return on capital, taxes, and so on, that private firms in the business would encounter. Much has been written about the Fed's role in payments, some of it by members of the Federal Reserve Bank of Minneapolis (Fernelius and Fetting 1992). Since the Fed is subject to a market test, there would seem to be no serious misallocation of resources as a result of the Fed's provision of payment services. Thus, it is unclear to me why England asserts that the Federal Reserve should unilaterally

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exit the business. There is, of course, the potential conflict alluded to earlier—the Fed’s dual role as regulator and market participant—but the Federal Reserve has been scrupulous about the “chinese wall” between policy and operating areas and, importantly, there has been extensive congressional oversight of the situation.

Benefits of the Fed’s Dual Role

A second and related point is that the dual role of the Fed as regulator and service provider has been of considerable value. This is true in a narrow sense, in that operational and payments system risk regulations are better when they come from an organization, such as the Federal Reserve, with hands-on experience in payments. The observation is also true in a broader sense because that first-hand experience and expertise in both roles has served the financial system and the economy well, especially during times of distress or crisis. With regard to recent experience, I am thinking specifically of some of the banking problems in New England of a few years ago and the difficulties with state-insured institutions in Ohio.

In asserting the value of the Fed’s dual role as participant and regulator, I recognize that I may sound more than a little self-serving and perhaps parochial as well. This concern brings me to the theme of England’s paper: restructuring the federal bank regulatory agencies. Again, I have only a few observations to offer.

From Regulatory Restructuring to Market Discipline

As far as I can see, the principal reason for regulatory restructuring should be to improve the effectiveness and quality of bank supervision and regulation, but not necessarily the efficiency or flexibility. Bank supervision and regulation can surely stand to be improved, but, in my view, regulatory restructuring is not likely to achieve that.

What is needed in bank supervision and regulation, in my judgment, is more market discipline, a message perhaps you did not expect from a Federal Reserve official. Recognize, however, that I speak only for myself on this, as well as other matters. At the Fed we have argued long and written extensively in favor of a form of coinsurance as the vehicle to bring the necessary degree of market discipline to banking. Thus, what I am about to offer is hardly new.

Federal deposit insurance, especially as it has evolved in recent years, creates a “moral hazard” problem. Insured depositors have little incentive to pay attention to the caliber of the banking institutions with which they do business. As a consequence, risk-taking in banking

is priced too low. Therefore, too much risk is taken on, leading to the now-familiar problems. More stringent supervision and regulation is one response to moral hazard, but I question its effectiveness, no matter how intense or intrusive. Moreover, supervision and regulation are not free—real resources are used in the process.

Coinsurance, on the other hand, would enhance market discipline in banking. By exposing depositors to some degree of risk, it would provide an incentive for them to pay attention to the caliber of their banking institutions. Coinsurance can be designed in several ways. To illustrate, say customers could be limited to one account, fully insured up to \$100,000, and anything over that amount would be exposed to risk of loss of, say, 10 percent of the uninsured balance. At this stage, these numbers are just suggestions, since we do not know precisely how well coinsurance would work, and we may want to experiment and gain experience.

In closing, let me add two additional comments about the coinsurance proposal. Not only is it a method for enhancing market discipline and dealing with moral hazard, but coinsurance also has the potential to deal with the difficult issue of “too big to fail.” Why? Since coinsurance limits depositor exposure, it also limits the size of the potential spillover effects of financial “accidents.” Hence, banks of any size can, in theory, be treated equally. Secondly, coinsurance could end the debate about applying market value accounting to banking. With the proper incentives, depositors can be counted on to use all available information and make whatever judgments and estimates they feel are of value to assess the condition of their bank. They will thus use market value measures, or approximations thereof, if they believe them to be valuable.

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