Currents

The Silly Season for Energy Policy

The new world order beckons. George Bush is bringing peace to the Middle East. The *Los Angeles Times* has proclaimed socialism a failure. Yuppies are going to church, and the Cubs are spending big bucks in the free-agent market. The full moon is past, Jupiter is aligned with Mars, and that handsome devil who used to smile at me from my mirror seems to have found greener pastures. But fear not, dear readers, some things are sacred indeed, foremost among them the widespread epidemic of Big Silly that afflicts politicos, pundits, bureaucrats, and other unendangered species whenever the phrase "energy policy" is resurrected in Washington. The symptoms manifest themselves mainly as demands for ever more governmental meddling in energy markets, usually in the form of efficiency standards, various subsidies and taxes, and other such tools of the bureaucratic game—always justified on purported grounds of market failure. Sufferers of Big Silly, on the other hand, appear to be unconsciously incapable of uttering the phrase "government failure," a symptom carrying profound implications for the one-sidedness of the public discussion.

The latest outbreak of this mental itching has followed publication of the *National Energy Strategy*, a Department of Energy document blending substantial good sense, a good bit of naïveté, and a dose of Big Silly as it advocates various policy changes to achieve greater allocational efficiency in producing and consuming energy in the United States. Concerned with the "foreign policy risks and the security costs" of dependence on unstable foreign oil sources, the *National Energy Strategy* advocates policies intended to increase domestic and foreign production that will be less subject to interruption. The report advances proposals to increase economic efficiency in the generation and use of electricity and in overall energy use by the residential, commercial, industrial, and transportation sectors and to reduce the costs of achieving given environmental goals. Many of the proposals are unobjectionable, and indeed they are designed to obviate the perverse effects of past or current policies.

Implicitly, therefore, the central contribution of the *National Energy Strategy* is its overall approach, to wit, a definition of efficient energy policy as an attempt by government to correct the adverse effects of conditions that cause market prices and marginal resource costs to diverge and thus reduce productivity in energy production and consumption. Accordingly, the *National Energy Strategy* avoids such time-honored errors as the facile equation of foreign dependence with "vulnerability" and the bland assertion—now as prominent as ever—that "conservation" is necessarily a good thing. After all, the domestic price effects of foreign supply disruptions are *independent* of the volume or degree of our foreign dependence, and conservation must mean the use of some other resources or the consumption of some other goods in place of oil or warmth or whatever. Suffice it to say that the evidence is exceedingly weak that alternative energy sources are less expensive or more socially desirable than traditional energy sources.

Ironically, however, this central virtue of the *National Energy Strategy* is also its central failing, for the strategy never comes to grips with the larger reality that various government policies are the primary source of divergences between the social values and costs of energy resource use. This long experience implies that a national energy strategy, however benign in intent, cannot avoid the perverting effects of interest-group politics, as politicians and bureaucrats pursuing private gain shape policies ostensibly intended to yield public goods or to reduce public bads. Thus, market failure arguments, even if demonstrated in some convincing fashion, are far from sufficient as rationales for governmental intrusion in energy markets. This larger myopia of the *National Energy Strategy* gives rise to a good deal of naïveté in its policy outlook as well as some Big Silly proposals, to which I shall return. For now, however, it is instructive to review briefly some of the major distortions that government has introduced in energy markets along with the implications of this consistent pattern of regulatory perversity.

Peak-period electricity prices almost certainly are excessively low as a result of state regulation based on average historical accounting cost. Offpeak prices may be excessively low as well, and other regulatory distortions probably reduce conservation investment relative to investment in generation. In addition, various federal policies—the Public Utility Regulatory Policy Act of 1978 foremost among them—yield important inefficiencies in the mix of generational investments.

More generally, a number of state and federal policies subsidize inefficient energy sources, some of them high cost in the extreme, in a purported quest to reduce U.S. dependence on foreign fuel. This rationale for energy independence, again, is incorrect, since the allocational effects upon the U.S. economy of changes in international oil prices are independent of the degree to which the U.S. economy is autarkic in energy supply. The actual effect of such policies, unsurprisingly, is the subsidization of various special-interest groups. The major adverse effects of these policies are an inefficient distribution of risk and an increase in bureaucratic meddling.

While we are on the subject of foreign oil, let us not forget the cost and value of private-sector preparation or insurance in anticipation of international supply disruptions. The market clearly expects that in the event of a serious cutoff the government will impose another round of price and allocation controls. Consider the widespread accusations of profiteering aimed at the oil industry in the wake of the increases in petroleum prices last fall. That this display of witchhunting was led by a Justice Department populated by good Republican burghers cannot inspire the private sector's confidence in a happy future. The result of such government intervention is the dual expectation that those who do not prepare for international supply disruptions will be subsidized, while those who do prepare will have their investments confiscated. That is a price-cost divergence par excellence, and it results from governmental meddling rather than from some sort of market "imperfection." The cost of the Strategic Petroleum Reserve is a crude measure (no pun intended) of the long-term damage done by the absurd policies of the 1970s.

There is no shortage of further examples. The nuclear generation industry is extremely underdeveloped as a result of a price-cost gap caused by perverse regulation, dishonest pressure group politics, and past cowardice in political and regulatory decisionmaking. The corporate income tax distorts most production and investment decisions. Insufficient investment is made, and investments that are made do not last long enough to produce significant results. Domestic crude oil, for example, is produced too quickly, and notwithstanding Orson Welles—may he rest in peace—all domestic wine is sold before its time.

The common thread among the areas in which clear divergences between price and social cost are present is the central role of government in creating or maintaining allocational inefficiency. It simply is not enough to ask whether market processes yield inefficiency. We must compare the imperfect market with the results offered by a decidely imperfect government. As a crude generalization, the benefits of even sensible policies will tend to be dissipated, perhaps completely, as the need to form political coalitions induces interested parties to invest in attempts to shape political outcomes and as democratic processes allow specific groups to garner part or almost all of the gains for themselves. It is, therefore, not surprising that the major source of curent price-cost gaps is the government itself. Nor is it surprising that the effects of past national energy policies have been far from salutary.

The external environmental effects of energy use are perhaps the most obvious source of divergence between prices and costs in the energy sector. Yet even in this area it is not clear that further policy to close the gap is indicated. Our efforts, mandated by regulation, to reduce air pollution alone are estimated conservatively to cost about $30 billion per year. The 1990 Clean Air bill will add at least $20 billion to that, in exchange for benefits that range from dubious to nominal. Most of these abatement costs are reflected in market prices. Thus, it is at least arguable that the current regulatory system closes the gap between price and social cost represented by environmental damage. That we receive a good deal less environmental improvement than we pay for speaks volumes about our current regulatory approach, but it is far from obvious that a price-cost divergence remains to be closed in the energy-environment context.

Can the authors of the *National Energy Strategy* possibly believe that the federal government simply will step in and with a discriminating eye "correct" existing divergences between prices and costs? Apparently so, for the strategy offers the caveat that "government intervention in markets must be justified by rigorous cost-benefit analysis." To rely on this admonition as an effective constraint on policy formulation, one must believe either that congressional outcomes will not be affected by competition among interest groups pursuing private gain

"WE'LL BE RUNNING AT FULL CAPACITY TODAY — SOME ENVIRONMENTAL GROUPS ARE SPONSORING A BIG MEGA-WATT ROCK CONCERT TO PROTEST COAL-FIRED PLANTS."

or that George Bush will veto any mischief that Congress attempts to engineer. If you can believe the former, as the old saying goes, you can believe anything; and the latter is a long shot. In short, the prospect that government policy will serve simply to correct market imperfections is mighty remote. That the *National Energy Strategy* implicitly has adopted this assumption bespeaks a surprising degree of naïveté.

Since the *National Energy Strategy* is a document produced by a government bureaucracy rather than by benevolent despots, it is not surprising that is offers some Big Silly of its own. Apart from the preservation and expansion of various "efficiency" standards, subsidies, and programs, the most prominent example is the proposed requirement that a growing percentage of fleet vehicles be able to use alternative fuels. The apparent rationale is the chicken-and-egg argument that such vehicles will not be produced by manufacturers until a fuel distribution network is in place, while the private sector will eschew investment in such a network until the vehicles (demand) are present. This argument is fundamentally incorrect since investment is driven by anticipated future demands rather than by current ones. There is nothing that prevents manufacturers of both the fuels and the vehicles from predicting the future profitability of a market for alternative fuels and vehicles and acting accordingly. The profitability of such investment is determined by future demands and costs. Governmental meddling cannot reduce the uncertainty about them. After all, if this *National Energy Strategy* argument is correct, how did an automobile-petroleum industry ever get off the ground? Radios? Television? Telephones? The market failure argument of the report implicitly denies the feasibility—without governmental intervention—of any industry for which investment is needed in inputs that are specialized to one another. The vast body of historical evidence speaks to the contrary. And have the report's authors ever heard of vertical integration? There is no reason that an entrepreneur cannot invest in *both* the (assumed) profitable vehicles and fuels and thus make a killing.

There are also other examples. The *National Energy Strategy* seeks to "promote mass transit and ride sharing" despite the larger reality that peak congestion cannot be reduced as long as the price of driving at peak hours is close to zero. The report "supports" ethanol and ETBE (ethyl tertiary butyl ether) and seeks to "develop new energy crops." If there is a reason the market cannot do these things, the report fails to mention it. Does Archer-Daniels-Midland not already have its snout sufficiently deep in the federal trough? And do the authors of the *National Energy Strategy* really believe that "the Strategic Petroleum Reserve . . . has demonstrated its capability to effectively address shortrun [*sic*] oil market disruptions?" Remember the confusion about use of the SPR last fall? Does anyone really believe that there exists anything other than a completely ad hoc policy for triggering the use of the SPR? If the report really believed in market processes, it would advocate that call options be sold for drawdown and use of SPR crude oil, so that the market rather than politics could allocate the oil over time. On this the report is silent, presumably because such market processes are inconsistent with the time-honored political and bureaucratic quest for enhanced power and authority.

Nor is the *National Energy Strategy*'s concern about "foreign policy risks and security costs" particularly convincing. The precise nature of the foreign policy risks is left to the readers' imaginations. As far as security costs are concerned, there may be a plausible argument to the effect that preserving access to cheap but insecure foreign oil by using military power is cheaper than simply diversifying away from such suppliers or an argument that providing such military power is, from the viewpoint of energy users, a public good with an attendant free-rider problem. That argument is plausible, but it is entirely undemonstrated. What part of the U.S. military force structure is attributable to such demands for military services? How costly is that part on the margin? What is the contribution of energy users to defense budgets? In any event, this "security cost" rationale hardly justifies anything as grandiose as the *National Energy Strategy* report; at most such a rationale might argue for a tax on energy use earmarked for specific defense purposes.

If anything is clear, it is the highly dubious nature of the prospect that the federal government institu-

tionally can improve resource allocation in energy markets. The premise implicit in the report that such improvement can be attained without introducing additional market distortions is at a minimum completely inconsistent with recent experience in the United States. The grotesque boondoggle that was the Synthetic Fuels Corporation was no aberration; nor were the price and allocation regulations for oil, the natural gas price controls, the oil import quota program, the pricing of federal electrical power, the differential treatment of western and eastern coal, and so on. Because the *National Energy Strategy* is the product of a bureaucracy with its own interests at stake, it is easy to believe that the underlying premise is disingenuous. A more benign interpretation is that the report is an attempt to derail even more mischievous proposals likely to emanate from Congress. Such proposals are likely to be forthcoming in any event, and confidence in the benign view would be stronger if the report had presented as a lesson the dismal history of federal government meddling in the energy sectors.

In short, then, safety lies in keeping the federal government out of the energy sector; the absence of a "policy" does not yield chaos, just as the presence of a policy would hardly provide confidence in the prospect of a larger economic pie. Quite the contrary, energy policy provides a vast sandbox in which innumerable and varied interests can garner benefits for themselves at the expense of other interests as well as the whole decentralized economy. Why, then, is energy policy like a mosquito that just will not go away? When asked why he robbed banks for a living, the infamous Willie Sutton replied, "'Cause that's where the money is." Why, then, the endless quest for an energy policy? 'Cause that's where the pork is.

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Treasury Report on Financial Reform Deserves Prompt Consideration

Modernizing the Banking System, the Treasury report on financial reform mandated by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), offers a number of excellent and politically courageous suggestions for modernizing our nation's banking system. The report's principal strengths are its recommendations to repeal the restrictions on geographic expansion by banks, to permit financial services holding companies, and to eliminate the statutory provisions separating banking and commerce. Its principal weaknesses are in the areas of regulatory restructuring and deposit insurance reform.

Repeal of Geographic Constraints

The Treasury report recommends that full nationwide branch banking be authorized within three years. In the meantime, a bank would be authorized to branch in any state in which its parent holding company can acquire a bank.

Nationwide branching is probably the single most important reform that could be made to strengthen U.S. banks. It will reduce overhead costs very substantially by allowing multibank holding companies to consolidate their various bank affiliates into branch operations. BankAmerica, for example, estimates that it could reduce costs by $50 million per year; other companies with more affiliates could save an even greater amount.

More important than the cost savings is the fact that nationwide branching will foster risk diversification. The most fundamental rule of banking is to control risk, and the principal way in which banks control risk is by diversifying their loans. The restrictions on geographic expansion have weakened our banking system by making it vulnerable to regional economic downturns. One statistic says it all: over 85 percent of the failed bank assets during the 1980s were located in just four states.

The Independent Bankers Association of America, contending that repeal of the restraints on branching will lead to the extinction of community banks, has vowed to wage war against Treasury's recommendation. Frankly, the IBAA does not have a leg to stand on. In the first place, the large banks have no desire (much less the capacity) to establish banking outlets in the smaller communities. Second, experiences with statewide branching in California, New York, and elsewhere demonstrate clearly that well-run community banks can compete successfully against the world's largest banks.

Financial Services Holding Companies and Banking and Commerce

The Treasury report's most controversial recommendation is that banks be permitted to affiliate in

financial services holding companies with other financial firms, such as insurance companies and investment banking firms, and that industrial companies be permitted to own financial services holding companies. The creation of financial services holding companies will result in stronger, more diversified financial institutions in the United States that are better able to compete with foreign financial institutions.

Some people contend that Congress should not authorize financial services holding companies because it will lead to repetition of the S&L debacle. Those who make this argument are either extremely ill-informed or are simply looking for an excuse not to act on reform. In the early 1980s the S&L industry had no capital and was losing vast amounts of money. The government reduced capital standards, authorized new high-risk activities to be conducted in the S&L itself by using federally insured deposits, engaged in accounting gimmickry to mask problems, and failed to strengthen examination and supervision. In contrast, the Treasury report addresses a banking industry that has over $200 billion in capital and is profitable. The report does not recommend that banks be permitted to engage in any new activities. Instead it recommends that banks be authorized to affiliate with separately capitalized and funded companies that engage in activities not permitted to banks.

Some argue that "firewalls" between a bank and its affiliates will not work and that trouble in the parent company or a nonbank affiliate will inevitably result in failure of the bank. If government leaders really believed this, they would not have enacted the cross-guarantee provisions in FIRREA. Readers might recall that the FDIC became frustrated because banks affiliated with failed banks in Texas and elsewhere were able to remain in operation and generated a windfall to holding companies' shareholders and creditors. The FDIC persuaded Congress to adopt the cross-guarantee provisions allowing the FDIC, in effect, to seize the affiliated banks. If affiliated banks operating in the same region with common names and logos could withstand the failure of the lead bank in a bank holding company, it is a safe bet that they could withstand the failure of a nonbank affiliate.

I have argued for nearly a decade that the prohibition against the ownership of banks by industrial companies could not be justified on safety and soundness grounds and that prohibition was weakening the U.S. banking system by denying it access to the broadest possible range of sources of capital and management. When the Bank Holding Company Act was adopted in 1956, there were virtually no problem banks or bank failures. The act's separation of banking and commerce was not intended as a safety and soundness measure. It was intended as an antitrust measure to prevent undue concentration of economic power. The U.S. financial system would be much better served by repealing the provisions separating banking and commerce and substituting targeted antitrust provisions (for example, a concentration cap prohibiting significant acquisitions if an organization controlled more than a certain percentage of the nation's deposits).

Regulatory Restructuring

The Treasury report recommends that the number of regulatory agencies governing banks and thrifts and their holding companies be reduced from four to two. The Federal Reserve would regulate all state chartered banks and thrifts and their holding companies, and a Federal Banking Agency located in Treasury would regulate all federally chartered banks and thrifts and their holding companies.

Two regulatory agencies are better than four. Moreover, unifying bank and holding company supervision is a significant improvement over the current system in which the Federal Reserve supervises a holding company even when all of the company's banks are supervised by another agency.

Treasury's recommendations on regulatory restructuring are flawed in two respects. The first relates to the FDIC. Treasury recognizes the need for an independent insurer to serve as a watchdog on the system. But the report fails to grant the FDIC sufficient authority to do its job by providing that the FDIC may not conduct an examination or take an enforcement action without permission from the primary regulator. It is difficult to fathom why Treasury would make such a recommendation in the wake of the S&L disaster. The S&L insurer, the FSLIC, was subservient to the primary regulator and was unable to blow the whistle on the primary regulator's attempts to sweep the S&L problems under the carpet.

Treasury's recommendations are all the more perplexing when one considers that it had before it an acceptable blueprint for reform carefully crafted in 1984 by the Bush Task Group, on which I served as chairman of the FDIC. The Bush Task Group recommended that the FDIC have the right to examine, in coordination with the primary regulator, all troubled institutions and a sample of nontroubled

institutions and to accompany the primary supervisor on all other examinations. It also provided that the FDIC could request the primary supervisor to take an enforcement action. If the primary supervisor failed to do so, the Bush Task Group recommended that the FDIC initiate its own enforcement action. Moreover, the Bush Task Group recommended that the FDIC be given the authority to set minimum capital standards for any bank it insures, to deny FDIC insurance for any new bank, to revoke deposit insurance for any existing bank, and to implement risk-based deposit insurance premiums.

The second flaw is that the Treasury report does not go as far as it should in recommending regulatory consolidation. While two agencies are better than four, one would clearly be better than two. The problem is purely one of turf. Neither the Federal Reserve nor Treasury wants to give up bank regulation, and they are both politically powerful. My preference would be to create a single, independent regulatory agency with a five-member board. The secretary of the treasury (or deputy), the chairman of the Federal Reserve (or vice chairman), and the chairman of the FDIC (or vice chairman) would be three members of the board with the other two members being a chairman and vice chairman appointed by the president.

Deposit Insurance Reform

The Treasury report's recommendations on reform of the deposit insurance system are a huge disappointment. Treasury essentially decided to punt on this issue, which is extremely unfortunate when one considers that deposit insurance reform is the principal subject Congress directed the Treasury to study in FIRREA. Moreover, most political strategists believe that deposit insurance reform must be the locomotive for the other reforms recommended by Treasury.

The Treasury report recommends that deposit insurance be eliminated on brokered funds—a very sensible reform that should have been enacted years ago—and be curtailed on multiple accounts—a depositor would be limited to $100,000 coverage per bank plus another $100,000 for an IRA. It also recommends that risk-based deposit insurance premiums be implemented—a sensible reform but by no means a panacea.

Where the Treasury report falls flat on its face is in its treatment of the too-big-to-fail policy. The report acknowledges the resulting unfairness between large and small banks and the undermining of discipline in the financial system, but fails to recommend that the policy be abolished. The report engages in some sleight of hand by transferring the decisionmaking authority over too-big-to-fail from the FDIC to Treasury and the Federal Reserve. No one even remotely familiar with the proclivities of the latter two agencies would suggest that they would be less likely than the FDIC to bail out a large bank, particularly when neither Treasury nor the Federal Reserve would be required to cover the cost of the bailout.

Treasury's failure to confront this issue is bewildering. The American Bankers Association endorsed a plan to end too-big-to-fail by imposing a mandatory 10 percent "haircut" on deposit balances above the $100,000 insurance limit whenever a bank of any size requires FDIC financial assistance. The ABA plan was recommended by the FDIC in its 1983 report to Congress entitled, "Deposit Insurance in a Changing Environment." Moreover, the 13 members of the Bush Task Group unanimously endorsed the plan in 1984. The road map had been drawn, and a political consensus had been achieved, but Treasury failed to seize the moment.

Overall, the Treasury report is a solid piece of work that deserves prompt and serious consideration by Congress. The report is not perfect by any means and needs to be subjected to extensive scrutiny and discussion. The report's signal deficiency is its failure to recommend abolition of the too-big-to-fail policy. That failure is almost inexplicable when one considers how much intelligence and courage Treasury has displayed in most of the other sections of the report.

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Capital Standards Alchemy

Nothing in banking regulation is as sacrosanct today as the new international capital standards adopted in June 1988 by the Basle Committee on Banking Regulations and Supervisory Practices under the auspices of the Bank for International Settlements. The major industrial nations of the world are now jointly phasing in these requirements for their banks, with full compliance scheduled for December 1992,

with no domestic review or legislative approval. Although some carp about the details of the regulations, no one seems to question the idea in principal of such international government-mandated capital requirements. It is not obvious, however, that such government regulation is desirable.

The Provisions of the New Capital Standards

The Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC) are now implementing the new standards for U.S. banks. Under the requirements, Tier 1, or "core," capital is limited to tangible equity, primarily including permanent shareholders' equity and retained earnings. This excludes such items as loan loss reserves, mandatory convertible debt, and all intangible assets such as goodwill. When fully implemented at the end of 1992, the new standards will require banks to hold core capital equal to at least 4 percent of risk-adjusted assets. As an interim step, since December 1990 banks have been required to hold such capital at a ratio of 3.25 percent.

In addition, the new requirements define Tier 2, or "total," capital to include subordinated debt with a maturity of five years or more, loan loss reserves up to 1.25 percent of risk-adjusted assets, and other items traditionally included in primary capital in the United States, besides the assets included in core capital. (The Basle accord allows each country to choose from a menu of approved items those it will include in Tier 2 capital.) Since December 1990 banks have been required to maintain a total capital ratio of 7.25 percent. By the end of 1992, banks must hold total capital equal to at least 8 percent of risk-adjusted assets. (U.S. banks will also continue to be required to satisfy a minimum ratio of 3 percent capital to total assets.)

The key feature of the new standards are the provisions for translating total assets into risk-adjusted assets, against which the required capital percentages are measured. In effect, these provisions seek to require higher capital for riskier capital assets. Under these provisions each bank asset is placed in one of four risk categories.

The lowest risk category includes items with no default risk, such as cash, U.S. government securities, and mortgage-backed securities guaranteed by the Government National Mortgage Association. The assets in this category carry a risk weight of zero, which means that they are not included at all in the risk-adjusted asset total against which the mandated capital percentages are required. Effectively, therefore, no capital is required for these assets. The second category includes assets with relatively low default risk, such as interbank deposits, general obligation municipal bonds, and mortgage-backed securities guaranteed by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation. This category carries a risk weight of 20 percent, which means that 20 percent of the value of these assets is included in the risk-adjusted asset total and thus effectively applies the mandated capital percentages to only 20 percent of their value. The third category applies a risk weight of 50 percent to items such as municipal revenue bonds and first mortgages on homes. All other assets, including commercial loans, are included in the last category with a risk weight of 100 percent.

Off-balance-sheet items are included in risk-adjusted assets as well. The face value of each of these items is first multiplied by a conversion factor to create a balance-sheet, credit-equivalent value. This value is then included in one of the risk categories, depending primarily on which category best fits the other party to the particular off-balance-sheet contract. For items that effectively extend credit or put the bank at risk of default, such as standby letters of credit or loan guarantees, the conversion factor is 100 percent. In other words, the entire face value of the commitment is counted as an on-balance-sheet item. For items that are a commitment to extend credit on demand, such as overdraft facilities, revolving credit, and home equity lines, the conversion factor, applied to the entire amount that may yet be loaned, varies depending on the remaining period during which the right to credit may be exercised. For periods over five years the conversion factor is 50 percent; for periods under a year the conversion factor is 10 percent. Once converted to a balance-sheet equivalent, most off-balance-sheet items would be included in the last category and risk-weighted at 100 percent, because they would involve commercial customers or consumers.

Market Socialism

One might ask how the regulators know that 4 percent core capital and 8 percent total capital are the right amounts for banks all around the world. Perhaps the level of capital should be less, perhaps it should be more. In fact, the regulators have no magic formula that tells them that the numbers they have chosen are the correct worldwide standard.

The relative weightings of the different categories of risk are similarly fairly arbitrary. Even if we grant that municipal bonds are in general less risky than first mortgages on homes, what tells regulators that they are less risky in a ratio of 20 to 50? Or what tells regulators that a first mortgage needs precisely half the capital as a commercial loan of similar size?

Lumping all of the assets of each type, such as commercial loans or first mortgages, in the same risk category for the same treatment is also quite crude. The credit risk associated with different commercial loans can vary quite a bit, as can different first mortgages and every other type of asset. The risk associated with each loan is affected by the creditworthiness of the particular borrower, the value of any collateral, and the terms of the loan. A portfolio of mostly commercial loans issued under strict standards can be less risky than a portfolio of mostly home mortgages issued under loose standards. Moreover, if problems develop with particular assets, such as late payments, impaired ability to repay, declining collateral value, or other asset-quality deterioration, those assets nevertheless remain in the same risk category. There is no greater capital required under the new standards. Conversely, if the quality of particular assets improves over time, perhaps because of an enhanced ability to repay or increased collateral value, this is not reflected anywhere in the new risk-based capital requirements.

The failure to distinguish among the widely varying risks represented by different assets in the same risk category can lead banks to increase risk in response to the new capital standards. If banks are going to face a capital premium when they invest in commercial loans, for example, then those banks may move from the safer, lower yielding loans to the riskier, higher yielding loans to recoup the costs of the increased capital requirements.

The new capital standards also focus primarily on default risk to set the relative risk rankings; they generally ignore interest-rate risk. No capital is required for long-term government bonds, yet a sharp increase in interest rates can sharply reduce the value of bonds with maturities up to 30 years. Traditional, fixed rate 30-year home mortgages, notoriously vulnerable to interest-rate risk, require only half the capital of three-month commercial loans, which have virtually no interest-rate risk. The capital standards mostly ignore liquidity risk as well. Short-term loans and securities are inherently less risky than long-term assets, yet the new capital standards offer no regard for portfolios with shorter-term maturities and no penalty for portfolios with longer-term ones.

Perhaps most damning, modern portfolio theory demonstrates that the riskiness of a portfolio cannot be measured by examining each asset individually. But this is exactly what the new capital standards do. The overall riskiness of the portfolio depends heavily on the interrelationships between the individual assets. Diversification among different types of assets, different industries, and different geographic regions can sharply reduce the risk of the overall portfolio, apart from the riskiness of any individual asset. Similarly, a portfolio with groups of assets whose performance is inversely related to each other is less risky than a portfolio with groups of assets whose performance is positively related, again apart from the riskiness of any individual asset. Thus, a well-diversified portfolio of relatively risky assets can be far less risky overall than a concentrated portfolio of relatively safe assets.

Focusing solely on the riskiness of each individual asset also overlooks the risk associated with possible asset-liability mismatches. Funding longer-term assets with short-term liabilities creates added risk, again apart from the riskiness of any asset. The short-term funding may be withdrawn before the longer-term assets mature. Rising interest rates can increase the cost of the short-term funding before returns on the longer-term assets increase. A portfolio of relatively safe long-term assets can, therefore, become much more risky if funded by short-term liabilities.

Finally, the focus on individual assets also overlooks the "going concern" value of the bank that can add greatly to its overall income-producing potential and therefore to the bank's true overall capital value. An established corporate client base, a stable core of deposits, a chain of well-recognized branches, a profitable credit card operation, and seasoned loan officers and executives who know their markets add to the profitability and hence the value of the bank. The stronger and broader these "going-concern" assets, the less risky is the bank overall. The new capital standards, however, do not recognize the effect of this going-concern value on risk or on compliance with the overall capital requirements.

The bottom line is that the new capital standards are not likely to be any more successful in accurately assessing the proper capital for varying risk than Yugoslavian market socialism was in creating prosperity. Both efforts attempt to mimic the market through central planning rather than to establish a

true market. And just as central planning can never accurately account for the infinite array of factors reflected in a truly decentralized market, so the centrally established risk-based capital standards can never fully account for all the risk factors that would be reflected in a truly free banking market.

In a free market banks that were more risky for any reason would have to hold more capital than banks that were less risky to continue to attract sufficient deposits and other funds. The market would appraise the riskiness of the bank as a whole and would therefore take into account each of the factors noted above. The objective forces of the market would determine how to weight different forms of relative risk in determining the overall level of capital each bank should have. This is the system of capital "regulation" that public policy should seek to establish.

The Problem: Deposit Insurance

This free-market capital regulation does not operate today because there is government deposit insurance. Such insurance effectively guarantees the bank. More risky banks need not hold more capital to attract sufficient funds because the risk to depositors is not affected by the riskiness of the bank's investments and activities.

Indeed, the introduction and expansion of deposit insurance has consistently led to reduced bank capital over time. The existence of deposit insurance requires the government to engage in capital regulation.

Because such central planning regulation can never be as effective and rational as a market system, public policy should instead focus on reforms that would allow a market system to function. If federal deposit insurance is not abolished or privatized, it should at least be changed to be more consistent with a free market. Government-mandated, risk-based deposit insurance premiums are not the answer, for they would involve the same sort of defective market socialism as risk-based government capital regulation.

Rather, the government could allow a bank to offer both insured and uninsured accounts. The insured accounts would be invested only in certain specified, highly secure assets that would provide separate collateral for the insured accounts; neither the bank nor any of its creditors could have any access or claim to such investments. The rest of the bank would then be an essentially unregulated universal bank, with the market determining its needed capital through the process described above.

This approach would continue to protect depositors against loss, at least to the extent that they desire such protection. But to accept this approach, one must also believe that the possibility of many accounts without government deposit insurance does not create a systemic danger to the banking system or to the economy as a whole because of possible runs on those uninsured accounts. This issue deserves more treatment elsewhere. But we may note here that the economic logic of government deposit insurance that must cover all accounts to guard against bank runs ultimately leads to the conclusion that the government must effectively socialize the banks as well.

Conclusion

The seemingly worldwide acclaim for the new capital standards reflects mostly the sentiments of the regulators themselves, perhaps because these standards greatly enhance the regulators' power. Such uniform international agreement means that the regulators do not have to yield to potential competition from other jurisdictions when they set their standards. The precedent set by the new international capital standards may lead to other power-enhancing international accords. Established banking interests have also embraced the new uniform capital standards because they seem to ensure that their banking jurisdictions will not set excessive capital standards that would put them at a competitive disadvantage. Such special-interest support for the new capital standards does not reflect the true public interest, however.

In the long run the celebrations over the new capital standards may prove to be premature. The specter haunting the banking system today is that in the modern marketplace nonbanks can and now do perform virtually every economic function of banks. The additional burdens and disruption imposed on banks by the new capital standards and other possible international regulations may simply increase the probability that the regulators will find their domains swept away by a tidal wave of securitization and money market funds with unlimited checking. Congress should review these new international capital standards before they create a general banking crisis that dwarfs the savings and loan debacle.

Peter J. Ferrara
Shaw, Pittman, Potts & Trowbridge

Insured Deposits and Exotic Financial Instruments: Where to Draw the Regulatory Line

Should insured institutions be allowed to invest in assets that federal banking regulators do not fully understand? Washington policymakers have again begun focusing on this question, which is not a new one, in response to the Treasury Department's recent banking reform initiative. At the risk of sounding flippant, one might similarly ask, should federal aeronautics regulators have blocked airlines from replacing their propeller planes with jets? The two questions are in many ways analogous.

The primary mission of commercial airlines is to provide safe, convenient, and affordable transportation to the general public. The government's role in regulating the airlines is to ensure that the industry fulfills its mission in a balanced and responsible manner. Clearly, the move to replace propeller planes with jets was consistent with the airlines' primary mission. Thus, federal regulators had an obligation to accommodate the airlines by acquiring the knowledge necessary to understand the jet engine's safety and soundness requirements.

The primary mission of commercial banks and thrifts is to provide safe havens for depositors' funds and at the same time to reinvest those funds in ways that help foster liquidity in lending markets that fall within the pale of the public interest. For example, the federal government began insuring and regulating the thrift industry in the early 1930s at a time when long-term home loans were unavailable in many parts of the country and available only at very high rates of interest in other areas. With governmental supports such as deposit insurance and the services of the Federal Home Loan Bank System, thrifts were able to make long-term home loans widely available at relatively uniform rates.

There is no denying that the question at hand has arisen from legitimate concerns. Should banks and thrifts be allowed to invest in assets that regulators lack the expertise to understand? In the spring of 1987, for example, a sudden spike in interest rates caused a variety of institutions, including some sophisticated Wall Street investment banks, to lose a great deal of money on their portfolios of so-called "high-risk" mortgage derivative products. Such products include bonds and residuals from collateralized mortgage obligations, stripped mortgage-backed securities such as interest-only securities and principal-only securities, and pass-through mortgage-backed securities with senior-subordinated structures. In the wake of this interest-rate spike, the Federal Home Loan Bank Board conducted hearings on the thrift industry's ability to invest in mortgage derivatives prudently. After all, some of Wall Street's top firms, with their extensive analytical resources, had suffered tremendous losses.

A closer look at the situation reveals, however, that although the bank board's concerns were legitimate, the focus of their inquiries was shortsighted, if not downright irrelevant. First of all, investment banks are not in the same line of business as commercial banks and thrifts. Investment banks are market makers; they earn money by underwriting new securities and by trading existing ones. In their trading operations investment banks work like flea markets. They purchase from sellers at one price and sell to purchasers at a higher price. The bid-ask spread represents their profit. Banks and thrifts, on the other hand, act as mediators between depositors and borrowers, not just by taking in deposits and issuing loans. but also by holding loans in their portfolios and managing their cash flows. Second, the fact that some investment banks lost a great deal of money on mortgage derivatives does not necessarily lead to the conclusion that these firms lacked the ability to manage their risks.

In the most widely publicized case of the time, losses resulted in part from a mortgage trader's taking some secret gambles. Perhaps most important, mortgage derivatives are nothing more than carved up home loan cash flows. No one can manage mortgage derivatives without a working understanding of the separate economic components that comprise mortgage cash flows. By the same token, anyone who is unable to make determinations about the safety and soundness of a mortgage derivative investment is probably also incapable of responsibly overseeing the management of a portfolio of whole loans.

These same principles have even wider applications. For example, the secondary market for derivative securities backed by Small Business Administration loans has blossomed in recent years. Investors can purchase SBA-backed interest-only strips or principal-only strips; they can purchase the rights to the 90 percent of interest and principal cash flows that are government-guaranteed or they can purchase the rights to the residual 10 percent of cash flows that lack government insurance. Without an understanding of the various risk components in SBA loans—such as credit risk, prepayment risk, and interest-rate risk—it is not

possible to invest prudently either in the loans themselves or in the derivative securities backed by the loans.

Before asking whether mortgage derivatives are too risky for thrifts to handle, the bank board should have first considered whether thrift industry executives and their regulators are capable of understanding the interest-rate, prepayment, and volatility risks inherent in all mortgage assets. A brief review of recent history seems to indicate that thrift executives and their regulators did not and still do not understand how to manage properly the most generic mortgage cash flows.

Before the Garn-St Germain Act of 1982, for example, the thrift industry was arguably in a deeper hole than exists today, and the hole was dug before deregulation permitted large-scale investments in assets other than home loans and before mortgage derivatives even existed. A former bank board chairman, Richard I. Pratt, has testified in a congressional hearing that when interest rates climbed some 10 percentage points between 1977 and 1981, mortgage asset values plummeted and rendered the thrift industry insolvent on a marked to market basis by $178 billion (more than $350 billion in 1991 dollars). This figure actually understates the problem because it fails to take into account liquidation expenses that are part of the cost estimates for today's thrift crisis. The depths of the first thrift crisis have been largely overlooked, however, because on the basis of generally accepted accounting principles (GAAP), the thrift industry was marginally solvent on the eve of the Garn-St Germain Act.

Now consider the fact that, according to a study released last March by the National Bureau of Economic Research, traditional thrifts—those primarily in the business of funding home loans—are still ticking time bombs. Researchers Patric F. Hendershott and James D. Shilling concluded, "Thrifts are even more vulnerable in 1989 than they were in 1977. The dollar volume of fixed-rate mortgages funded by short-term deposits in 1989, $400 billion, is slightly greater than it was in 1977, and thrifts have also put over $325 billion of adjustable-rate loans with rate caps on their balance sheets. A sharp rise in interest rates would cause significant losses on these capped loans, as well as fixed-rate loans."

Other studies have shown that, after taking into consideration the costs of overhead and capital and the costs of neutralizing interest-rate and prepayment risks, most thrifts simply cannot make money in the business of managing a portfolio of home loan cash flows. The so-called "option-adjusted spread" for most thrifts in the mortgage business these days is negative. Many thrifts that look profitable on a GAAP basis are actually losing money on an economic basis, and it is just a matter of time until economic reality again catches up with the accounting.

Facts such as these demonstrate the absolute futility of quibbling over whether banks and thrifts should be allowed to invest in this class of financial instruments or that class of financial instruments without first determining what lines of business insured institutions ought to be in and how the risks and profitabilities of these businesses ought to be measured. Current debates over the specific investments of depository institutions are comparable to approving the plans for the plumbing system in a new building before determining the purpose the building will serve. Once this purpose has been determined, however, the shape of the building's foundation and structure will follow logically from this purpose, and the plumbing system will follow logically from both the purpose and the shape.

Policies Require Solid, Logical Foundations

Taking this analogy a step further, it is reasonable to conclude that even a lifetime government guarantee on a plumbing system would not attract buyers or instill confidence in insurers of a building that is supported by stilts on the edge of a seaside cliff prone to mud slides. And yet, by making ad hoc determinations on esoteric issues, such as whether banks and thrifts should be allowed to invest in high-tech financial instruments, federal policymakers are trying to impose a sense of lasting order in the hopes of inspiring confidence in the taxpaying public and encouraging wealthy investors to infuse new capital in the industry. The simple fact is that most people are quite capable of discerning whether government policies are built on solid, logical foundations and therefore likely to last.

Accordingly, as a necessary first step toward resolving the matter of banks' and thrifts' buying high-tech financial instruments, Congress should address a series of fundamental questions. Why should deposits be federally insured? What public policy is thereby served? What is the primary mandate of federally insured institutions? What activities should banks and thrifts fund with their insured deposits? How can accounting standards better reflect reality? How can deposit insurance be structured to encourage competence and discourage incompetence? What tools and training do

regulators require to do their jobs properly? And finally, what are the primary mandates of the regulatory agencies?

Once such fundamental issues have been resolved, the answers to more esoteric questions will become almost self-evident. For example, in response to the question whether banks and thrifts should be allowed to invest in assets that regulators lack the expertise to understand, it would seem that Congress should set parameters on the types of loans insured institutions can own (for example, home loans, consumer loans, and business loans) and then require that industry executives and regulators be educated and tested on their understanding of cash flows from loans that fall within those parameters. It is easy to see, however, that the efficacy of such a policy would be predicated on the willingness of Congress to resolve the more fundamental questions listed above.

Having said all this, we have yet to illustrate the benefits or detriments that might accrue from a policy of allowing banks and thrifts to use innovative, complex financial instruments. To do so, consider once again the example of mortgage derivative products, instruments that came into existence just a few years ago. First, the liquidity provided by an active secondary mortgage market has helped reduce mortgage rates relative to what they would have been otherwise. High-tech innovations have helped mortgage lenders to find new sources of funds and in turn have helped make the dream of home ownership far more attainable for countless people. Furthermore, the derivatives created by the investment banking community can be powerful and indispensable tools for managing the interest rate, prepayment, and volatility risks inherent in all mortgage obligations.

It is quite clear, however, that any useful tool has a destructive potential. That is why the gods of mythology were reluctant to give fire to humans. And certain examples from the thrift industry fiasco graphically illustrate the magnitude of the damage that can result from allowing uninformed, incompetent, or wrongfully motivated officers or regulators to operate. If the federal government does not want to be in the business of administering education and examination programs for industry officers and regulators, why not simply require that they pass the Chartered Financial Analyst series of exams? After all, financial officers at banks and thrifts are in fact investment managers, and their regulators are in fact investment analysts. Continuing a policy that denies this reality and then denies banks and thrifts the freedom to capitalize on innovations will greatly limit the ability of insured institutions to fulfill their missions.

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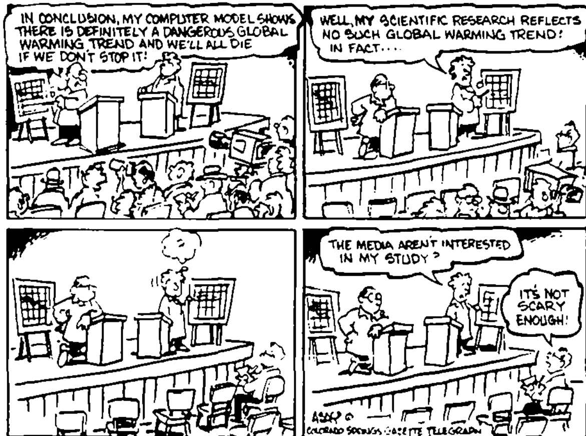
A Recipe for Sustained Environmental Growth

Barring a worldwide calamity, environmental issues will continue to vie for center stage over the next several years. We are continually besieged by information suggesting that environmental problems are of catastrophic proportions—do not eat apples sprayed with Alar, hold the Perrier, stop using disposable diapers, recycle newspapers. With this steady bombardment of dos and don'ts, it is small wonder that consumers are overwhelmed.

Unfortunately, our political leaders do little to help the situation. While they seem quite effective at heightening our awareness of the perplexing array of environmental issues that may require attention, our leaders are less effective at devising innovative solutions to those problems in a way that promotes economic growth.

The critical challenge is to develop sound policies that will facilitate continued environmental and economic improvement—that is, "sustained growth." Sustained growth can be attained only with a strong, growing economy that judiciously addresses environmental concerns. The recent experience with the command-and-control approaches embraced by the Soviet Union and Eastern Europe serves as a stark reminder that this model did not promote economic growth or environmental improvement. Indeed, EPA Administrator Reilly has cogently argued that the key to environmental success lies in taking advantage of "the green thumb of capitalism." I agree. My purpose here is to spell out my view of Administrator Reilly's vision along with some of the potential challenges in promoting environmental and economic growth.

Successful solutions to environmental problems can be achieved by taking the following five not-so-simple steps:



• *Prioritize environmental problems.* Politicians have been reluctant to separate important from trivial environmental problems. They have taken the easy way out by suggesting that all problems are important. Our environmental expenditures could be spent much more wisely if a concerted effort was made to separate the environmental wheat from the chaff. To EPA's credit, the agency has begun to develop an information base that would help prioritize environmental risk. A critical question is whether such information will be used in actual policy formulation.

• *Define judicious objectives.* Defining judicious objectives requires comparing the costs and benefits of various policies, something that the environmental community generally eschews for fear that some regulations would be rolled back. If the goal is to stimulate sustainable growth, however, we must devise a framework that includes both environmental and economic costs and benefits incurred by the general public, especially where sizeable expenditures are involved.

• *Develop innovative approaches for problem solving.* To their credit, both Congress and the administration have recently become more supportive of new "incentive-based" approaches to environmental regulation. These approaches encourage producers as well as consumers to search for innovative environmental solutions. The basic idea is to create property rights for environmental goods so that individuals, businesses, and governments have a continuous incentive to incorporate the cost of pollution into their everyday decisions. The design of these approaches has been nicely laid out in several recent studies, including *Project '88,* a report cosponsored by the late Sen. John Heinz and Sen. Timothy Wirth on market-based solutions to environmental problems and an ongoing EPA study, which identifies a mind-boggling assortment of potential applications for economists' tools. Notwithstanding the temptation to support a full-employment act for economists, we should not become so immersed in the application of tools that we lose sight of the importance of choosing the right problem. We are in very real danger of taking a fast train to the wrong station, as evidenced by some recent proposals for using markets to achieve mandatory recycling targets, which themselves may be undesirable.

• *Implement innovative approaches for problem solving.* Writing about new ideas for promoting environmental innovation is one thing; implementing them is quite another. The recent Clean Air Act Amendments of 1990 contain a pathbreaking market-based proposal to control acid rain by reducing sulfur dioxide emissions by 10 million tons. Utilities and other industrial sources are given the flexibility to choose how best to achieve the required reductions in sulfur dioxide emissions. Critics of this legislation suggest that even in this case, the benefits from such reductions are speculative and the costs are substantial. There is widespread agreement, however, that this market-based approach has the potential to save as much as $2 billion annually over more traditional technology-forcing approaches.

• *Learn from our successes and failures.* Program evaluation is critical if we are to make progress toward ensuring sustainable growth. We think we know how innovative environmental approaches work in theory. We are much less certain how they will work in practice. Thus, there should be a continuing assessment of the efficacy of all regulatory tools as well as the selection of particular goals. Given our incomplete understanding of complex environmental processes, we are doomed to failure if we become prisoners of the status quo.

This five-step recipe for sustainable growth is currently little more than a pipe dream. The good news is that we are beginning to develop the kind of information that is needed to help ensure that we are on a path that fosters sustainable growth. While Administrator Reilly has been instrumental in encouraging the agency to rank risks and develop new innovative approaches, there remains a curious omission of costs in most discussions of environmental policies. For obvious reasons, politicians prefer to highlight "win-win" situations, which help

both the economy and the environment. While such silver bullets are attractive, the search for constructive environmental solutions should not end there. Hard environmental policy choices that involve significant economic and social tradeoffs must inevitably be made. The remaining question is whether information comparing the benefits and costs of these policies will be used in making key environmental decisions.

With few exceptions, this need for balance currently lies beyond the grasp of the political process. Most politicians and environmental advocates continue to perpetuate the myth that industry can absorb whatever environmental costs are imposed by government without passing them on. Voters, however, are not so easily deceived, as the recent defeat of California's Big Green initiative made clear. They recognized that the public will inevitably pay, one way or the other, until someone invents a free lunch.

Sustainable growth relies on the presumption that a healthy environment and economy are inextricably intertwined. In many cases recent environmental policy has lost sight of that link. The way to rectify the balance is for the government to focus on big-picture problems—to choose the right regulatory tool for the right problem and then to leave it to the ingenuity of the individual to help preserve our heritage for generations to come.

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Geographic Restrictions on Banks: A Prescription for Disaster

In the United States commercial banks are subject to a variety of geographic restrictions that regulate the number and location of banking offices. These restrictions include: the McFadden Act, which forbids nationally chartered banks from branching outside their home state and subjects them to state branching restrictions within their home state; state laws that limit or prohibit intrastate branching; the Douglas Amendment to the Bank Holding Company Act, which forbids bank holding companies from acquiring out-of-state commercial banks unless state law in the target bank's state expressly permits such acquisitions; and state laws that limit or prohibit bank holding company acquisitions.

Geographic restrictions increase the likelihood of bank failures, reduce competition within the financial services industry, and thwart the efficient operation of the banking system. Such restrictions are unique to the United States; no other major industrial country has similar regulations.

History of Geographic Restrictions

Current geographic restrictions on American banks have a long history. With the notable exceptions of the First and Second Banks of the United States, eighteenth and nineteenth century federal and state banking laws forbade banks from branching. Fearing that large, nationally branched banks might drain funds from "legitimate" agriculture and rural commerce to fund "speculation" in the cities, agrarian interests advocated geographic restrictions to assure local control of the availability of credit. The executives of community banks also championed these restrictions to shelter their banks from the rigors of competition from larger and potentially more efficient branched banks.

A series of financial panics culminating in the Panic of 1907 made banking reform a major political issue. The abolition of branching restrictions was widely proposed as a solution to recurring regional crises, and California did adopt statewide branching in 1909. At the federal level, however, the policy solution was the creation of a central bank in 1913.

During the Depression, especially in the early years, most bank failures were confined to small rural banks with undiversified loan portfolios, and support for more liberal branching laws arose again. But the banking panic of late 1932 and early 1933 destroyed public confidence in the entire banking system. In response to demands for immediate government intervention, federal deposit insurance was introduced in 1933.

Since the 1930s, the states have gradually liberalized their bank branching laws. As of January 1, 1991, 36 states plus the District of Columbia permitted statewide branching, 13 states permitted limited area branching, and only one state forbade branching.

The interstate bank acquisition movement began in 1975 when Maine enacted the first general purpose interstate bank acquisition law. As of January 1, 1991, 47 states plus the District of Columbia had enacted some form of general purpose interstate

bank acquisition law. Thirty-two states currently allow bank holding companies throughout the country to acquire intrastate banks, while 14 states plus the District of Columbia limit interstate bank acquisitions regionally.

To date state laws require that all interstate banking acquisitions be made through holding companies. A bank holding company is a parent corporation that controls one or more commercial banks and may engage in certain other bank-related financial activities through nonbank subsidiaries. Geographic expansion is more costly when accomplished through a holding company structure, however, than when it is accomplished through branching.

Under a holding company structure each subsidiary bank maintains its own board of directors, officers, and accounting system. Likewise, each subsidiary bank is separately capitalized for regulatory purposes. In contrast, branches share common management, information systems, and capital. Costly duplication may thus be eliminated if separate subsidiary banks can be consolidated into one bank.

Recent judicial and legislative decisions have sparked a renewed interest in geographic restrictions. In February 1987, the Fifth Circuit Court of Appeals upheld the comptroller of the currency's use of the more liberal thrift branching laws for purposes of determining the McFadden Act restrictions on national banks. In response, five states have adopted statewide branching laws, while one state has imposed its bank branching restrictions on thrifts. Moreover the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) amended the Bank Holding Company Act to allow bank holding companies to acquire thrifts and to allow thrifts to convert to bank charters, provided the newly chartered bank continues to pay premiums into the thrifts' deposit insurance fund. The Resolution Trust Corporation (RTC) has argued that, taken together, these provisions effectively override state bank branching laws when selling failed thrifts to bank holding companies that convert them into banks. Both the Eighth and Tenth Circuit Courts of Appeals have upheld the RTC's interpretation.

Geographic Restrictions and Bank Failures

Geographic restrictions limit the selection of assets available to banks and force them to hold geographically concentrated portfolios. By inhibiting the geographic diversification of assets, these restrictions increase the likelihood of failure due to local economic downturns.

Loans comprise a majority of the assets on a bank's balance sheet. For a variety of economic and legal reasons, banks naturally extend most of their loans to customers in communities where they maintain banking offices. Information and transaction costs increase when a bank lends to customers from other communities. Although the size of a multimillion dollar loan (a line of credit to IBM) or the volume from a standardized loan product (credit cards) may sometimes offset these costs, high information and transaction costs discourage banks from extending loans that require some customization (small business loans) or frequent on-site inspection (construction loans) to borrowers outside the local community. Moreover, the Community Reinvestment Act of 1977 places an affirmative obligation on banks and thrifts to "help meet the credit needs of the local communities in which they are chartered" to "reinvest" in their communities, particularly in minority or low-income neighborhoods.

Both economic studies and recent events demonstrate the harmful effects of geographic restrictions. For example, the contrast between the performance of the American and Canadian systems during the Depression is striking. Unlike the United States with its severe branching restrictions, no such restrictions have ever been placed on Canadian banks. Of the 23,631 U.S. banks in existence on January 1, 1930, 8,812 or 37.3 percent of the total failed during the next four years with estimated depositor and stockholder losses exceeding $2.5 billion ($21 billion in current dollars). In sharp contrast, no Canadian banks failed between 1929 and 1933, although Canada sustained an equally severe contraction in output and prices.

Various studies have also found that bank failure rates since 1933 are lower in states that permit statewide branching than in those states that do not. Similarly, empirical studies have demonstrated that banks with multioffice operations are less likely than unit banks to be classified as problem institutions.

More recently, the problems of banks in farm and oil-producing regions during the 1980s underscore the harm that geographic restrictions inflict on the banking system. States in those regions have historically had some of the most severe restrictions on intrastate branching and multibank holding companies. These restrictions tied the asset portfolios of banks in those states to the fortunes of the oil industry or local farmers. When the prices of

agricultural commodities and oil fell in the mid-1980s, banks in those states failed in post-Depression record numbers. Almost two-thirds of all bank failures in 1986 were in the Dallas and Kansas City Federal Reserve Bank districts, where most of the nation's farm and energy banks are located.

In 1930 Comptroller of the Currency John W. Pole noted: "Under a branch system . . . it would be possible for the parent banking business to protect itself against economic depression in any one locality or in any one industrial activity or business enterprise. It would then be able to extend to the country districts the same quality of banking services and the same safety to its depositors which the customers of metropolitan banks in the large cities now enjoy." Pole's observation is as relevant to policy discussion today as it was 60 years ago.

Geographic Restrictions and Competition

Not only do geographic restrictions increase the risk of individual bank failure, they also reduce competition in local banking markets and encourage monopolistic behavior. These effects have been confirmed by a number of economic studies examining the effects of barriers to entry and of new entry into banking markets.

When geographic restrictions limit entry into local markets, the prices of financial services to consumers and businesses are higher then they would be in more competitive settings. In addition, employee and officer-related expenses tend to be higher in banks where entry is strictly limited by branching restrictions. Such restrictions also frequently allow protected banks to earn an abnormally high return on their investment, and they prevent banks from attaining an efficient size.

Geographic Restrictions and Consumer Welfare

Finally, geographic restrictions inhibit the efficient operation of the payment system, increase cash management costs for businesses, and inconvenience consumers. Removing geographic restrictions would speed interbank funds movements and increase economic efficiency.

In a system of mainly unit banks, a check drawn on one bank and then deposited at another unaffiliated bank often has to pass through a chain of correspondent banks and clearinghouses before it returns to the bank of origin. The clearing process can consume considerable time and resources. Wider branching that would develop after complete geographic deregulation would turn many costly interbank check payments (transit items) into less expensive internal funds transfers within the same bank (on-us items). As endpoints are consolidated, banks could reduce the sorting and handling costs of the remaining transit items and realize transportation economies through direct exchange. The volume of transit items moving through clearinghouses or correspondent banks would decline. It has been estimated that with full nationwide banking, the Federal Reserve's share of the check processing market would decline from its current 32 percent to between 13 and 18 percent. While difficult to estimate, the cost savings could be substantial. And since many noncheck payments, especially wire transfers, could also be internalized, there would be additional savings of a similar magnitude.

Both consumers and businesses would benefit from the increased convenience offered by geographic deregulation. Currently, consumers must select a new bank when they move from one state to another or even when they move from one community to another, if they live within a unit banking or limited branching state. Removing these restrictions would allow many customers who move from one state to another to simply transfer their records to another branch in their new community.

Geographic deregulation would also allow business firms with operations in many states to simplify their banking relationships and reduce cash management costs. Currently, business firms handling large amounts of cash, such as retailers, must open checking accounts with commercial banks in each state, if not in every community, in which they operate. The absence of branch facilities imposes significant cash management expenses on such businesses. Geographic deregulation would relieve businesses of this heavy burden.

Conclusion

Geographic restrictions on commercial banking organizations harm bank customers in many ways. These restrictions tend to raise the price of financial services to consumers and businesses and create supranormal returns for banks in protected markets. Furthermore, these restrictions increase the risk of bank failures and tend to destabilize the financial system.

In 1985 Alan Greenspan, currently chairman of the Federal Reserve Board, summarized the case for geographic deregulation: "In my judgment, further deregulation, such as the repeal of the

McFadden [Act] and Douglas Amendment, would probably go a long way toward improving the situation [in the banking industry]. Indeed, what is necessary to solve the problem effectively is the freedom of greater diversification for depository institutions so they can reduce overall risks. It is obvious that the inhibitions still posed on interstate banking prevent the maximization of diversification and the reduction of risk, and in that sense these inhibitions, which serve no useful purpose and indeed are probably counterproductive, are creating additional problems for depository institutions."

Robert P. O'Quinn
Staff, U.S. House of Representatives

The Dockside of Regulation

Before the
FEDERAL FASHION COMMISSION
Washington, D.C. 2000X

In re Docksider Shoes—) Dkt. 82-911
Petition for Seasonal Exemption)

TWEED, COMMISSIONER, for the Commission:

The Docksiders Users League, Limited ("DULL"), a West Virginia nonprofit corporation, has petitioned the Commission for a waiver under Section 214(b) of the Fashions Standards Revitalization Act of 1953 (99 U.S.C. § 914(b)) ("the Act"), for seasonal relief from the Commission's Compulsory Fashion-Following Rules (99 CFR §§ 1 ad naus.) ("the Rules").

DULL argues that Docksider Shoes ("DSs") have been classified as "compulsory sockless footgear" under Section 1812 of the Rules; and, as a result, ordinary citizens of fashion-conscious age are unable to wear DSs in a manner that maximizes private comfort and perhaps public decency. To be specific, DULL argues that DSs originated as summer shoes to be worn on water navigational devices ("boats"), where convenience and necessity were served by not having wet socks. See *Docksiders—Waterborne Use,* 44 FFC 1312, affirmed 744 F.2d 34 (*"Docksiders I"*). Despite these utilization origins, it became established through custom as a "trendy fashion" (as defined in § 2942(c)(i) of the Rules) that DSs were not to be worn with wet socks, or any other socks.

The Commission has already developed extensive administrative experience in dealing with this product. Following *Docksiders I,* we authorized nonboat use of the DSs in riparian states, *Eagle Yacht Club,* 66 FFC 1029 (*"Docksiders II"*); and then extended authorization to all states to simplify the growing administrative burden, *Nevada League,* 13 FFC 2d 558, *affirmed sub nom. Fitchburg Boot & Shoe Co.* v. *FFC,* 919 F.2d 69 (*"Docksiders III"*).

Now comes DULL and petitions the Commission that DSs are suitable for nonboat winter wear, but they are unreasonably cold and uncomfortable unless worn with socks during winter months. The Commission, recognizing the superficial plausibility and general good sense of this argument, remanded the petition to the Teen Trend Bureau ("TTB"), for a report on the engineering and/or environmental hazards of having DSs worn with socks. The TTB has responded that it deals with fads and fashions, not environmental harm. The Commission, after due consideration of the TTB report, has determined that "enough inquiry is enough." *Stopbotheringus, GMBH,* 12 FFC 88, 94, *reversed in part,* 901 F.2d 1281, *reinstated on remand,* 64 FFC 269, *appeal dismissed as moot,* 989 F.2d 13. Accordingly, the Commission rejects the argument of the Fashion Promotion League ("FPL") for a full evidentiary hearing under Section 337 of the Act. The Commission really does not like full evidentiary hearings. *In re Beltless Pants,* 43 FFC 3rd 19, *summarily reversed sub. nom., Maverick Industries* v. *United States,* 1229 F.2d 1414.

Instead we find that although it may be true that DSs are truly summer shoes, see *Docksiders III,* they are not necessarily entirely inappropriate for nonsummer use. Accordingly, we feel that the public convenience and necessity will be served by avoidance of "seasonal loss of opportunity" as defined in

Section 18(a)(1) of the Rules. We, therefore, shall not foreclose DS users in less temperate climes from maximizing their equipment investment by utilizing said equipment during winter months in nonboat applications.

The Commission has given lengthy consideration to the issue of what constitutes "winter months" for the purposes of DULL's waiver application. We do so because excessive waiver would disrupt the free market in sockless shoes and short pants. *In re Local Union 39,* 44 FFC 28. Accordingly, we find that "winter months" constitute the months of September through June in Maine and Minnesota, and the months of December through February in Georgia. *Cf. Bikini Bathing Suits,* 28 FFC 2d 69, *dismissed with prejudice,* 33 FFC 2d 982. We remand for the staff to consider states with climates of intermediate temperance between these extremes on a case-by-case basis. See *Fluff 'n' Stuff Inc.,* 88 FFC 717.

We make as an ultimate finding the determination that a large part of the public does not notice whether people wear DSs with or without socks. Accordingly, we find the granting of this limited waiver in no way creates an offense against peace, order, and good government in the fashion world. *Night Owl,* 14 FFC 2d 1224, *aff'd* 918 F.2d 312, *cert. den.* 881 U.S. 1091.

Petition granted in part.

MUMBLE, COMMISSIONER, dissenting:

This petition should never have been accepted by the Commission. The question at bar is not one of public "fad or fashion" (as defined in Section 201 of the Act) but of private utility and comfort. Nobody can pretend that DSs look better with socks, and hence there is no "profound conflict of public taste." *Outraged Citizens League* v. *United States,* 811 U.S. 466. Instead it is a question of sheer utility and comfort, which could more properly be treated by the Federal Utility Commission ("FUTZ") under its organic statute. I reject the idea that questions of fashion should be subordinated to utility and comfort. That is a job for others, not us.

HARDRIGHT, CHAIRMAN, concurring:

Fad and fashion should be deregulated. Every fashion-conscious competitor should be free to offer whatever he (or she) wants in the market. Bare ankles, but not bare bottoms, should be a matter of private interest, not Commission judgment. Ankles with socks may be less interesting, but they do not so offend against "the common conscience of mankind" as to invoke the Commission's jurisdiction. *In re Beautyfit,* 93 FFC 2d 14.

I would grant DULL's petition without examining the facts.

Donald I. Baker
Sutherland Asbill
& Brennan

The Case against Cartels among Governments

One of the benefits of free trade is that it may increase the competition among governments as well as among firms. One should not be surprised that neither governments nor firms prefer competition (except among their suppliers). Governments, however, make the rules, and they have a greater potential to restrict competition in the market for policies than do firms in the markets for goods and services. One of the more disturbing developments in recent years is that governments have colluded to impose restrictions on the competition among themselves as a condition for approving rules that increase the international competition among firms.

The continuing developments to complete the Europe 1992 project are a case in point. As late as a year ago, there was a substantial conflict of visions about the future of the European Community. Then-Prime Minister Margaret Thatcher proposed to maintain the competition among European governments on most policy issues in concert with the change of rules that would increase intra-European trade. Most regulations would be subject to the country-of-origin principle approved by the European Court of Justice in 1979, and the government of each country, at least Britain, would maintain the authority to choose its own monetary and fiscal policies. European Commission President Jacques Delors, however, had a different vision of Europe 1992 as the economic framework of a European federal state. Many regulations would be "harmonized" by the Eurocrats in Brussels, the European Monetary System would be transformed into a European central bank with a common currency, and at least some characteristics of welfare policies, rules affecting corporate governance, and tax rates would be jointly approved by the European Parliament. For the moment, Delors appears to have won

"It doesn't look good. Some of our nationals are at war with some of our other nationals."

this conflict of visions on all counts. John Major, the new British Prime Minister, appears to have embraced the expanded vision of Europe 1992, and there is no longer a leading European spokesman for the case for competition of policies in a free trade area. The problems of developing a common currency and a common "Social Charter," however, are difficult and will not be resolved soon, so there is still an opportunity for the Europeans to head off the increase in the average levels of regulation, inflation, and government spending and tax rates that would surely follow the reduction of competition among the European governments.

A second example is the Basle agreement on international capital standards for banks. This agreement was approved by an international committee of central bankers in 1988, with no domestic review or legislative approval, and is scheduled to be fully implemented by the end of 1992. The perils that will result from this agreement are summarized in the Current by Peter Ferrara in this issue.

The most recent example was the debate in Congress on the U.S.-Mexico free-trade agreement. House Majority Leader Richard Gephardt wrote U.S. Trade Representative Carla Hills that any trade pact with Mexico must also include provisions on the rights of unions to organize workers, on health and safety standards in the workplace, and on environmental standards. In addition, Rep. Charles Rangel demanded that any trade pact also commit the Mexican government to increase enforcement against drug exports to the United States. In effect, Congress was close to stating that it will permit free trade only with those countries with labor, health and safety, environmental, and, possibly, drug enforcement regulations similar to those in the United States. Increased international competition in goods and services would be allowed only on the condition that the competition on policies would be reduced. This position was also supported by those industries and unions that are threatened by increased trade with any country. As this note was written (in mid-March), this alliance threatened to defeat the renewal of the fast-track authority necessary to complete both the Uruguay round and the Mexican agreement.

The positions of the European governments, the central bankers, Congress, and the interests threatened by free trade are understandable, albeit unattractive. None of these parties prefers competition in their own markets. On a conceptual basis, however, there is no reason to restrict the competition among policies unless the policies of one government impose a physical (not pecuniary) externality on other countries. In terms of their own interests, for example, both the average American and the average Mexican are better off with different environmental regulations, except in those cases where environmental policies in one country have a significant effect on environmental conditions in the other country. There are good reasons for international agreements on use of the world's common pool resources—such as the electronic frequency spectrum, orbital slots, ocean fisheries, and the ozone layer—or for reduction of such international threats as wars and communicable diseases. There are no valid reasons for restricting the competition among governments on such policies as antitrust, labor regulation, and most health and environmental regulations.

Congress would be well served by reviewing the Basle agreement on the capital standards for banks before this agreement by the central banker's cartel creates serious problems. The American public would be well served by restricting Congress from making cartel agreements with other governments on a wide range of other policies.

W.N.