Remarks by

Gary H. Stern

President
Federal Reserve Bank of Minneapolis

American Enterprise Institute
Washington, D. C.
October 27, 1999

The issues raised by the title of this conference -- Is Bank Regulation Necessary? -- are challenging and, to answer the question directly, I think bank regulation is necessary, for reasons having to do with credibility and too-big-to-fail (TBTF) institutions. I'll elaborate on that point a bit later, but what I really want to spend my time on this morning is why more market discipline of banking organizations is desirable and, in fact, necessary. Given this emphasis, it almost goes without saying that I am speaking only for myself and not for others in the Federal Reserve.

By way of overview, the thrust of my remarks this morning is that, while rhetoric now favors increased market discipline -- along with preservation of the existing safety net and supervision and regulation -- implementation of market discipline lags. Given the current state of play, as I read it, the most fruitful approach at the moment to achieving greater market discipline may be to incorporate market signals into the existing regulatory framework. I have some specific suggestions on how market signals can be generated and used in the regulatory process. The idea is to begin to redress the imbalance between reliance on supervision and regulation and reliance on the market. Also, I will offer some thoughts on market discipline in comparison with other, possibly helpful, suggestions which in fact constitute a different approach. And finally, I will conclude with some comments on further "evolution" in this area.

Let me start to get more specific by describing the current state of play with regard to the safety net, supervision and regulation, and market discipline. As I see it, the banking policy debate is in the process of shifting toward serious consideration of increased market discipline, but this shift is occurring without a commensurate consideration of reduction in regulation or in the scope of the explicit safety net, particularly deposit insurance. Several developments have brought these circumstances about, including:

a. recognition of the costs -- direct and indirect -- of government support for bank creditors;

b. recognition of the potential benefits of market assessment of bank risk taking and its implications for the management of that risk taking;

c. recognition of the limitations of supervision and regulation, in light of earlier banking problems here and abroad and the increased size and complexity of banks.

The consequence of these factors is that the terms of the debate have shifted, with the rhetoric moving toward an increased role for markets. We now see, more or less routinely, calls for increased market discipline from a wide group of policymakers and others. However, this shift in sentiment has not, with few exceptions, been accompanied by practical proposals to actually enhance market discipline or by real enthusiasm for doing so. What we need from the supervisory and regulatory community, as well as the research world, are initiatives to implement market discipline.

Moreover, the shift in rhetoric has not involved sustained calls to reduce the role of deposit insurance and/or supervision and regulation. Most proposals call for market signals to augment supervision and implicitly accept the existing safety net. There is not much enthusiasm for the idea of a "quid pro quo" -- i.e. somehow limit the safety net and, in return, limit regulation.

One might ask why there is so little interest in explicitly limiting deposit insurance and/or in reducing supervision and regulation? Part of the answer is probably the result of rational calculation: there is little interest in doing so because then one is vulnerable to being blamed for subsequent banking problems and/or for heightened depositor concerns. Further, there is the apparent correlation between inadequate supervision and poor outcomes. And some groups actively support the status quo.

Most importantly, in my judgment, there is the credibility issue, especially in the case of TBTF institutions. Plans to limit or to eliminate regulation and safety net support founder on the expectation that the government will step in in TBTF cases. Failure to recognize this expectation could result in diminished regulation and the same degree of moral hazard. In other words, a pledge of "no government intervention" is not credible in the case of TBTF banks, and pretending that it is would be harmful. More positively, there is evidence that regulators add value, having access to information and analyses not readily available.

Given this state of play, the most fruitful approach available may be to build a framework which introduces an increased role for market discipline into the existing regulatory regime. Such a step would start to redress the imbalance between reliance on supervision and regulation and reliance on market discipline. Moreover, I believe this is the direction we have to go over time -- it is irresponsible not to do so -- because of public policy considerations of both effectiveness and resource utilization. That is, market discipline will add to the effectiveness of supervision, and it is an efficient way to do so. After all, traditional supervision is not a free good, but rather a significant volume of real resources is used in the process. (I could elaborate on these points, but the theme is clear in the balance of my remarks.)

As I see it, FDICIA was a regulatory response to the banking problems of the 1980s, so there is little reason to believe it addresses some fundamental issues in regulation. For example, even with FDICIA, regulation cannot readily determine the proper marginal pricing of bank risk and the amount of bank risk taking that is economically efficient. And it cannot, in my view, lead to prompt closure of failing banks.

What should we do? To redress the imbalance and achieve increased market discipline, we must find a way to generate credible market signals of the riskiness of our largest banking institutions. Several proposals can accomplish this, including:

a. Co-insurance (Federal Reserve Bank of Minneapolis)

b. Subordinated debt (Academics and Federal Reserve)

c. Reinsurance

The basic idea underpinning these proposals is to put large depositors or other significant creditors of large banks at greater risk than they are today, so that they have more incentive to pay attention to the caliber of the banking institutions with which they do business.

The details of these proposals are by now familiar and I won't repeat them, except to remind us that the plans should focus on the largest banks, and the existing safety net can largely be retained. These proposals also allow for gradual implementation, so disruptions, if any, can be contained. And I want to reiterate that the plans achieve increased discipline from large depositors or other significant creditors; they do not change the circumstances for small, unsophisticated depositors.

It is important to recognize that these plans are structured so that bank regulators have less reason than at present to "bail out" creditors of TBTF institutions. That is because spillovers are limited in these proposals, so regulators do not have to worry excessively about problems at one institution affecting others or the economy more generally.

As we succeed in generating market signals of bank riskiness, we want to incorporate these signals into the regulatory framework. There are several ways this might be achieved, including:

a. incorporate them in trip wire schemes, such as prompt correction action;

b. incorporate them into setting of deposit insurance premia;

c. incorporate them into authority to engage in new activities -- the recent banking legislation has a bit of this.

Use of market signals in supervision and regulation requires converting the rhetoric to action. And in so doing, we need to distinguish between market discipline and other

reforms. For example, requiring banks to disclose more information more quickly may be helpful, but presumably only after large creditors have been more explicitly put at risk, so that they have incentive to care about additional information. Indeed, with improved incentives, creditors will demand additional information and banks likely will find it to their advantage to provide it. A regulatory mandate for more disclosure may be unnecessary.

Similarly, use of an institution's internal risk estimation or risk management models may be helpful in the supervisory process. But they are not the same thing as an external assessment of bank risk taking -- use of internal models do not constitute true market discipline and should not be construed as such.

Finally, given the evidence that market participants can assess bank risk taking -- and, more generally and importantly, the acknowledged effectiveness of markets in allocating resources throughout the economy -- the burden of proof, now, should be on those who oppose these kinds of reforms. Do we really need additional evidence before moving to greater reliance on market discipline? I think not.

Looking further into the future, I would think there will be a good case, and therefore a good chance, that the mix between reliance on regulation and on market discipline will eventually change more substantially than the proposals enumerated here. As we proceed, policymakers will gain experience with market signals and market discipline, so both expertise and comfort levels should rise over time. Both traits -- expertise and comfort -- are essential to the credibility and continuity of greater reliance on market discipline. When a problem engulfs a large banking organization or some other part of the financial sector, regulators, with high levels of expertise and comfort, will have the confidence to continue to rely on market discipline.

Further evolution of the banking business is also likely to lead to increased reliance on market discipline. It appears that large banks are becoming, and are intent on becoming, more like other providers of financial services -- insurance companies, securities firms, and so forth. To the extent they succeed, we will want, as a matter of public policy, to adjust the regulatory framework and safety net appropriately, so that the right "model" is in place and is applied as banking changes. We will want to assure that the disciplinary system fits the contemporary financial system.

Thank you.