Major Threats to the Financial Services Revolution

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First, the good news: the financial services revolution is alive and well and will continue to provide valuable new credit and risk-spreading instruments. These new instruments will have important effects on the structure of nonfinancial firms and industries. Maybe more important, the increased globalization of the markets for financial instruments will reduce the exploitive potential of all governments.

Now for the bad news: the major uncertainty is whether American banks will be allowed to participate in this revolution. Our government has recently overreacted to the collapse of the savings and loan insurance fund by a substantial reregulation of both the S&Ls and the commercial banks without, I suggest, adequately addressing the problems that led to the S&L crisis. The major constant is that government will continue to be a part of the problem, not the solution to the remaining real problems. In some cases, the government will protect existing services against the new services, declining firms and industries against the entrepreneurial firms that provide the new services. In other cases, several pending government measures pose major threats to existing financial services and industries. As a specialist in federal economic policy, let me focus on the major governmental threats to this revolution.

Banks

The most visible problem of the commercial banks is a reality, not a threat: Congress has overreacted to the S&L collapse by an extraordinarily complex web of new regulations on the premise, apparently, that if some regulation is desirable, more regulation is even better. Bill Haraf (1992) at Citicorp probably expressed this best in the following words:

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> The architects of FDICIA made sure that virtually every idea anyone once had to enhance the safety and soundness of depository institutions found its way into the law. Let me offer an analogy to illustrate why. An elderly gentleman with a number of vague, but modestly debilitating symptoms arranges appointments to see his internist, a chiropractor, a surgeon, his dentist, a proctologist, and even a faith healer to seek advice about his health. They all recommend programs of treatment based on their training and experience. The proctologist, I might add, proposed a particularly ambitious treatment plan. Confused about the conflicting advice, he undertakes them all. Three months later, after being drugged, reamed, racked, bled, root canaled, purged, blessed, and otherwise tortured, the poor old gentleman died.
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> FDICIA includes, among other measures, risk-based premiums, early intervention, market discipline from large depositors, Reg Q-type deposit ceilings, brokered deposit and pass-through restrictions, tougher accounting and audit standards, discount window reforms, mandatory operational and managerial standards, closer supervision, higher effective capital standards, enhanced risk-based capital standards, limits on activities of state chartered banks, and more. In addition, burdensome new consumer provisions, such as the misnamed Truth in Saving Act, were also added. Many of the new regulations which found their way into FDICIA were based on sound and useful ideas. In combination, however, they could not be remotely justified by any sensible cost/benefit calculation. Judging from the experience of the elderly gentleman, the prognosis for banking is not good.

And these measures may also have had a serious effect on the general economy, particularly on those firms that do not have direct access to the capital markets. During the first 12 months in which the FDICIA regulations were in place, commercial banks reacted by increasing their holdings of U.S. government security by $99 billion and reducing their commercial and industrial loans (C&I) by $15 billion. This is the first time that this combination of investment patterns has been observed during the early stages of an economic recovery.

C&I loans are now lower, in nominal dollars, than in December 1988, and are now smaller than their holdings of U.S. government securities. My reading of this evidence, which I acknowledge has been disputed, is that we are experiencing a rare combination of a generally expansive monetary policy and genuine credit crunch primarily affecting small business. The package of measures announced by the Clinton administration, involving such minor issues as the conditions for which there must be an appraisal of real estate used as collateral, do not substantially change this condition. FDICIA, a measure designed to make deposit insurance safe for the taxpayers, is transforming banks

into lenders to the government, a credit function for which the banks have no comparative advantage.

The major new threat to the banks is the potential for credit allocation. The Clinton administration, not satisfied with their power to influence the flow of new saving, is apparently considering measures that would mandate an allocation of some part of the $3 trillion of bank portfolios to politically favored groups—such as inner cities, small business, and racial minorities. The recent charge that banks have discriminated by race in their mortgage lending is especially egregious—a charge that is based on the questionable premise that bankers have foregone opportunities for profit in favor of racial prejudice and that is wholly inconsistent with the evidence that the default rates do not differ by race.

The increase in deposit insurance premiums and regulation has already led some major banks to consider dropping their bank charter. And the new threats to bank portfolios could turn this into a stampede. The American commercial banking industry will and should undergo a major shakeout. The issue is the extent to which this will be a result of ill-conceived government regulation or of market forces.

Insurance Companies

Insurance companies face two major threats. The Clinton administration will apparently propose some form of "managed competition" in health care in which everyone in a region would pay the same premium for a basic package of medical services. This would effectively eliminate any insurance role for the insurance companies. These companies may still provide claims processing services and organize some of the provider networks, but the present system of health insurance would be transformed into a system of medical care prepayment plans with no significant insurance dimension. The transition to this system is also expected to include a several-year period of federal control on both insurance premiums and on provider compensation.

The other major threat is the prospect of federal solvency regulation. A several hundred-page bill that would establish the first federal regulation of insurance company solvency has already been proposed by Congressman John Dingell (D.-Mich.). The primary problem of this proposal is that the states would maintain the authority for rate regulation. The separation of solvency and rate regulation would remove any remaining discipline on the state regulators with the prospect that they would reduce their maximum allowed rates.

There is a way out of this conflict, similar to the dual-chartering system for banks. Insurance companies that opt for a federal charter

would be subject to federal solvency regulation but would be freed form any state (or federal) rate regulation. Other companies with niche markets would maintain their state charters and continue to be subject to state regulation of both solvency and rates. The proposal by John Dingell should be taken seriously, but there is an opportunity to turn this threat into an opportunity.

Pension Funds

The major threat to pension funds is similar to that for banks—the prospect of federal control of their portfolio of assets. Alicia Munnell, assistant secretary for economics in the Treasury, has long proposed eliminating the tax deduction on pension contributions and accruals. More recently, she has supported direct federal controls on a substantial part of pension assets on the questionable promise that these assets were not sufficiently taxed in the past. Banks and insurance companies should recognize their common interests in opposing these massive potential regulatory takings of their existing assets.

Derivative Markets

The final and continuing threat is the potential for increased federal regulation of the markets for derivative financial instruments. Such measures have long been supported by the Securities and Exchange Commission and some of the major Wall Street securities firms. In retrospect, it seems like a fortunate historical accident that the markets for these instruments have been allowed to develop under the light regulation of the Commodities Future Trading Commission. It would be especially tragic if these markets were subject to increased regulation just when the American business community is learning to use these instruments effectively to reduce the risks in the variance of their input or output prices.

Conclusion

In summary, the problems of the existing regulation of financial markets are serious, will significantly affect the structure of the financial industry, and will delay or reduce the potential benefits of the financial services revolution. My guess is that most of the major threats that I have summarized will not happen. For these threats to be avoided, however, we will have to make our case to both those who are potentially most affected and to the wigging wonders of Washington.

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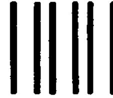

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