Overview of the Commission's Philosophy and Recommendations

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Introduction

The regulatory environment in which deposit intermediaries operate was to a large extent fashioned in the 1930s. Although a number of changes in the regulation of financial institutions have been made in the last four decades, the majority of academics, legislators, managers of financial institutions and regulators would agree that the pace of regulatory change has been slower than desirable. In large measure this is attributable to the complex relationships among the institutions and the legislative and regulatory processes which consider change on a piecemeal basis. Alterations in the regulations governing one set of institutions invariably affect the other types. The introduction of proposed legislative or regulatory change invariably calls forth efforts by those adversely affected to modify or defeat its adoption, and these efforts are often successful.

The President's Commission on Financial Structure and Regulation was given the task of recommending changes which would improve the performance of the financial system and, at the same time, have a high probability of being implemented by the federal regulatory agencies, the Congress and, where appropriate, by state legislatures and regulators. The major advantage of a commission is that it, in contrast to regulators and legislatures, can take a system view of the operation of the deposit intermediaries. This allowed the Commission on Financial Structure and Regulation to develop a package of interrelated recommendations. Each recommendation moved in the direction of improved performance. In light of political reality, the package was designed with the hope that interested parties would coalesce to support the entire set, even while the same recommendations, taken individually, would have small likelihood of acceptance.

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The Report of the President's Commission on Financial Structure and Regulation contains 89 recommendations. Since the contents of the report are by now well known, we will not detail all the recommendations. Very briefly, the Commission recommended, among other things, that:

1. In the immediate period interest rate ceilings on time and savings deposits be used only in the event of the threat of serious disintermediation; that, if ceilings must be used, the inter-institutional differentials on the ceilings currently existing be removed within five years; and that the ceilings be entirely eliminated within 10 years.
2. All deposit institutions be permitted to offer third-party payment services, with identical reserve requirements and equal tax and regulatory burdens.
3. Savings and loan associations and mutual savings banks have a far wider range of loan and investment powers.
4. Charter conversions from one institutional type to another and from mutual stock forms be made easy to implement.
5. Regulatory provisions be made to authorize all types of financial institutions to offer the sorts of finance and finance-related services allowed bank holding companies, subject to the same public interest and the same competitive safeguards as apply to bank holding companies.
6. Social priority investments be implemented by direct subsidies to consumers and/or tax credits on interest income to all holders of debt instruments directly related to such investments.
7. Federal regulatory agencies by reorganized in the interest of efficiency and more effective monetary policy.

There clearly is some sentiment in academic circles – and scattered feelings outside of academe – that the recommendations should have gone further. Immediate – or, at least, faster – abolition of Regulation Q has a good deal of support. Many would urge that elimination of the prohibition of interest payments on demand deposits should have been recommended. Similarly, rather than imploring states to be progressive in their policies toward branching, as recommended by the Commission, there is considerable sympathy to the view that the McFadden Act should be repealed to permit true interstate branching and the end of locational protection through state banking laws. Variable-rate deposit-insurance premiums, based on differential risk factors, also have support.

We have no intellectual quarrel with our colleagues who would have gone further. Rather, our concern is with the possibility that the *Report*, consisting in our view of the minimal necessary changes to permit financial institutions to serve the public efficiently and effectively in coming years, may not gain the support necessary for legislation and administrative action. We suggest here that further piecemeal adjustments of the regulatory structure are a far worse course for public policy than the Commission's recommendations. We suggest, too that the critics of the *Report* – not the academic critics who would have gone further, but the supporters of the *status quo* – have failed in their criticisms to make clear just what these alternatives are.

In the period since it was made public the *Report* has been the focus of broad study and discussion. For the most part statements by trade association leaders and government officials have been favorable but they usually conclude with a cautious "wait-and-see" attitude. None of the responses to the *Report* since its release is a great surprise, despite the conscious design to fashion *The Report* with a view to achievability. The world has changed in ways that make the subjects of *The Report* seem less important. We think they are quite as important as they were in 1970; failure to consider them could lead to results far inferior to those recommended by the Commission.

The Commission was established during a period of considerable domestic monetary unrest. Funds flows were at the time being diverted from the traditional deposit intermediaries. The commercial paper market had grown enormously – and had demonstrated its proclivities toward crises. Eurodollar borrowings were rising. Direct placements of small-denominated debt obligations by substantial borrowers were in the offing. Residential construction received very limited funds from traditional sources, and new borrowing techniques were being developed by larger borrowers and lenders. States and municipalities faced financial crises and small businesses were badly squeezed for both long- and short-term capital requirements. On top of this, and to some extent for related reasons, one-bank holding companies were rapidly expanding in number and in proposed activities. Something, it seemed, had to be done.

Something was done. There was patchwork revision of Regulation Q – largely in the form of its abolition on large denomination certificates of deposit, where it failed to work at all. New programs were initiated by federal housing agencies and by the Federal Home Loan Bank Board. But, most important of all, monetary restraints were

eased so that the depositary intermediaries and their customers faced financial markets which were much more "normal". In other words, without apparent crises the pressure for change subsided. Yet *The Report* looks forward to the possibility of future crises and seeks to avoid them. None of the changes to date in any way mitigates the dangers the Commission foresaw.

Foundations of the Commission's Recommendations

Almost immediately after its formation, the Commission made a number of fundamental decisions. It would not act as a "fire brigade", making emergency recommendations on immediate and conceivably interrelated problems on an *ad hoc* basis, *in seriatum*, as the gravity of such problems might dictate. Nor would it, with the power of hindsight, report on problems of the past and policy failures related thereto. Instead, it chose to consider the complex interrelationships among financial markets and, with the uncertainty which always accompanies forecasting, to ascertain how these markets were likely to operate over the years ahead, given what seemed to the majority of the Commission to be the most probable course of events.

The Commission settled – rightly, we think – on two important projections concerning the coming decade or two. First, while the situation was regarded as far from ideal, the Commission felt that periodic or possibly chronic pressures toward inflation were probable. There was little debate as to whether these pressures were fiscal, monetary or "cost-push" in origin. There was little explicit debate about "Philips curve" trade-offs between inflation rates and unemployment. Regardless of basic causes and regardless of such trade-offs, the Commission concluded that monetary policy was likely to be used from time-to-time in the future as an anti-inflation measure. Restrictive monetary policy seems to have become an institutionalized response to inflation. Thus, periods of fluctuating and periodically high rates of interest, with their concommitant differential effects on various segments of financial markets, were accepted as "good" forecasts for the future.

The second projection is less obvious from the text of the *Report*, but no less important in the Commission's recommendations. Financial markets had undergone pervasive changes based on new technologies in the years immediately prior to the Commission's being established. The materials and views the Commissioners discussed and considered gave little evidence that the opportunities

for change afforded by technology would appear at diminishing rates in the future. Moreover, these opportunities seemed to include alternatives to branching for extending the geographic area served by particular institutions and to reduce the importance of entry barriers arising from state branching laws. Here the evidence is largely from the revealed interests and behavior of borrowers and lenders, but it seemed to the Commission – again, correctly in our view – as extraordinarily persuasive.

These technological changes which influence financial institutions have originated, for the most part, outside the institutions. That is, the basic technical advances have occurred in scientific activities and in research and development programs carried on for reasons quite apart from changes in production methods and product offerings of financial institutions. In fact, one might argue that the institutions themselves have been slow in their rate of adopting new methods and products which technology makes possible.

There was a strong view within the Commission that the failure of financial institutions to take full advantage of technically feasible and economically rewarding alternatives was in some measure the result of regulatory inhibitions. An equally strong view arose that if the existing institutions were denied the opportunity to adapt to new technological opportunities, new institutions – unregulated at the outset, at least – would arise specifically because of those opportunities. The development of the Eurodollar market, the rise of the commercial paper market, the popularity of one-bank holding companies, the possible growth of direct placements of small-denomination debt instruments by major borrowers, the emergence of real estate investment trusts, the growth of the "third market" in corporate securities, innovations in third-party payment services by thrift institutions and credit unions, the spread of bank credit card systems, the growth of loan-production offices of commercial banks, the new functions and services performed by mortgage bankers, the adoption of electronic clearing systems for check payments, the ease with which large businesses could keep working balances in interest-bearing securities, and the imaginative, if not always permissible, schemes developed by commercial banks to accommodate the demands of savers for higher interest and the needs of borrowers for adequate funds – all of these gave credence to the view that technological opportunities had far outrun those relevant when the existing regulatory structure was fashioned.

It would be a mistake to suggest that the Commission uniformly foresaw the "checkless society" as a reality in the near future. But it

is no stretch of the truth to say the Commission foresaw that some rather indefinite changes would continue to be afforded by technology which, in the absence of fundamental regulatory reform, would result in possible "second-best" adaptations to the new technologies by new institutions and a gradual decrease in the role of traditional institutions in the intermediation process. Precision in the definition of future developments was impossible to attain; strength in the view that it would occur was nonetheless clear.

An Evaluation of the Policy Alternatives

Commissions obviously have no claim to infallibility; this one may prove to have been wrong in its assessment of the future. In either case, right or wrong, the consequences of the principal recommendations being adopted and their not being adopted can be considered. That is, what are likely to be the main differences in social costs and benefits if: (a) the Commission was correct and its recommendations are accepted; (b) the Commission was correct and its recommendations are rejected; (c) the Commission erred and its recommendations are accepted; and (d) the Commission erred and its recommendations are rejected?

Alternative (a): This alternative is the one which the *Report* itself assumes and only a few additional points need to be made. While acceptance of the recommendations would permit institutions to adapt to changing monetary and technological conditions, the Commission recognized that some firms – those which are inherently inefficient and those whose managements fail to make appropriate adjustments – would fail. On balance, the Commission felt that these failures would yield net social benefits and not reach such proportions as to cause system-wide complications. The alternative to the recommendations would be anticompetitive protection regulations and, during some monetary conditions, industry-subsidization programs which would produce both inefficiency and a slowing of technical progress with attendant high social costs.

The most vocal objection to the *Report* under this alternative has been that the flow of funds to housing would be adversely affected and, consequently, that national housing goals would not be met. Some have said that both the cyclical variation in mortgage funds flows would continue and that the long-term flows would be inadequate.

We feel there is little question but the cyclical problem of housing finance would be alleviated under the Commission's recommen-

dations. Private institutions supplying mortgage funds would be better able to attract funds during periods of rising interest rates and the differential impact arising from the supply side would disappear. It may, of course, be true that the demand for housing finance is more interest-elastic than that of other borrowers and cyclical sensitivity from this side would continue. If the relatively elastic private demand fails to capture the full social benefits of high levels and reasonably constant rates of housing construction, supplementary public programs would be required. The Commission supported such programs.

Beyond this, we feel that national housing goals are more complex than is expressed by a global figure of, say, 2.5 million starts per year. In fact, the latter objective seems more appropriate for a program to support the building industry than one to meet public housing needs. National housing shortfalls vary across income groups, across urban, suburban and rural classifications, and, after correction for income, perhaps across racial groups. The direct subsidy approach adopted by the Commission is certainly a finer tool to correct specific kinds of housing shortfalls than are existing financial regulations on thrift-institution asset portfolios and subsidies and quasi-subsidies which are determined by institutional types.

We should not conclude this section without admitting that additional social benefits on allocative-efficiency criteria could be expected if the Commission's recommendations had included some additional changes. Of these, the most significant, quantitatively, would be the removal of the restriction on the payment of interest on demand deposits.

The social costs imposed by not adopting most of the others often suggested are either expected to be short-lived because of the Commission's phase-out period or relatively small because new technology will reduce their impact. The Commission recognized the social costs imposed by this restriction but decided on a judgmental basis that the broad set of changes recommended would severely stretch managerial ability to make adjustments and that the desirability of removing the interest-rate prohibition should be evaluated after experience with the new regulatory environment is available.

Alternative (b): If the Commission was correct about future monetary and technological conditions and its recommendations are not adopted, a number of economically disturbing and socially costly developments will emerge. Because of the monetary conditions, financial institutions with slow-turning asset portfolios will have both earnings and liquidity adversely affected when rates rise. If, as we

believe, the deposit customers of these institutions will be quicker to disintermediate in the future than in the past, and if new types of intermediary markets will be formed more quickly in the future than in the past, the situation could become acute without extreme monetary tightness and extraordinary higher interest rates. That is, more system-wide complications including the possibility of high failure rates, could develop under this alternative than under alternative (a).

Emergency enactment of the Commission's recommendations in such circumstances would be to no avail. A period of adjustment is necessary for them to work. Regulation Q, as it existed, would be even less effective than in the past in protecting the institutions and maintaining the desired flows of funds. Conceivably, interest-rate maxima could be extended to all sorts of financial instruments – but then the cost effect of monetary policy on restraining aggregate demand would be lost. Further, except as the rate maxima were manipulated to achieve the purpose, interest rates would not operate to allocate resources among alternative ends.

We doubt the efficacy as well as the efficiency aspects of global interest-rate controls. Gaps between the funds demanded and those supplied at the controlled rates would exist generally, yielding at least temporarily the desired effects on aggregate demand due to availability effects. The gaps would almost certainly result in uncontrollable "black markets", however, and disintermediation from the "legitimate institutions" to the "black markets" would occur rapidly. In short, we do not think universal interest-rate controls are a preferable alternative to the Commission's approach.

If interest-rate controls would not work well, the remaining policy alternative would be to subsidize the failing instituitons in some way. Operations by federal agencies in secondary markets, special reserve allowances, special discount privileges and tax relief would be among the possible ways to achieve the results. All of these would operate in a direction contrary to that dictated by monetary policy, yet they could be defended by reference to sacrosanct housing needs – and sundry other social goals as well as the need to preserve large numbers of deposit institutions from defaulting. In our view, it would be rare that social goals could in fact be efficiently achieved by subsidies to the institutions. Again, the Commission approach seems preferable.

Technological change, unlike changing monetary conditions, is unlikely to lead to acute effects of crisis proportions. Instead, failure

to adopt the Commission's recommendations would provide preferences to some organizational types over others and some institutions which might efficiently innovate would be denied the opportunity to do so. Inefficiency – in the sense that possibly non-optimal organizations would be supported – would result, with the possibility of a gradual withering-away of some of the traditional institutional forms. The thrift institutions are prime candidates for playing a relatively less important intermediating function if they are denied third-party payment services and other "full service" financial lines of commerce. Similarly, since existing law favors the holding company organizational form as a means of utilizing technological opportunities, this organizational form would probably grow relative to divisional and subsidiary organizational arrangements.

Projections over the decades ahead indicate the possibility of very substantial changes. Technology is quite likely to bring pressures on state legislatures to permit state chartered institutions – mutual savings banks and credit unions, in particular – to engage in activities denied to their federally-chartered counterparts. Similarly, business firms which now utilize the traditional intermediaries will discover preferred means for funds transfers, some of which will utilize new market organizations, and some of which will be handled through intergration and non-market mechanisms. In short, whether the Commission's recommendations are accepted or not, new technologies which provide new services, better-quality services, or cost reductions will ultimately be used by someone, somehow. To deny existing institutions the opportunities to innovate makes little sense to us.

Alternative (c): If the Commission erred in its views of future monetary and technological conditions and yet made its case so persuasively that the recommendations were favorably acted upon, still different consequences would occur. Chief among these is that financial markets would be more competitive. And the prime reason for the increase in competition would be the reductions in entry barriers which would occur. Whether or not actual entry took place on a large scale, existing institutions would be permitted to extend product lines in competition with other types of institutions and to expand the geographic dimensions of their markets. Easier entry into finance-related markets would exist and, via holding company and subsidiary affiliations, even the barriers formed by state lines would be reduced.

Understandably, these results would be unwelcome to both financial and non-financial businesses which are protected by the

present regulatory framework. They would be adversely affected. But if competitive theory has any applicability to policy problems, it is hard to conclude that the results would not be socially beneficial. The Commission, it should be recalled, recommended nothing to weaken the force of antitrust laws in inhibiting changes with anti-competitive consequences. Only competitively neutral and pro-competitive changes would be encouraged.

This alternative has consequences for housing finance, also. Since, by assumption, periods of tight money and high rates of interest do not occur, the cyclical character of housing which relates to squeeze from the supply of funds side are immediately ruled out. To the extent that institutions currently specializing in housing finance diversified, however, with no reverse diversification from others not currently in that market, a smaller flow of private funds would be available.

Whether or not this change would be socially beneficial depends on externality conditions and on the choice of policy tools to deal with externalities. If private demand and private costs accurately reflect social valuations – a condition which we personally reject because we believe that housing has clearly manifest externalities – the reduced flow of funds to housing would be the correct change in resource allocation. On the other hand, if private demand under-values the social benefits of housing, or particular types of residential construction, the effects of increased competition, by themselves, are not allocatively efficient.

It is our view that externalities do exist in the housing area and, indeed in many other areas. Protecting financial institutions and the presently constituted building industry are not the social goal we have in mind, however. The goal is to build the type of residences, in the locations, and for the people to which the externalities pertain. We remain of the view that direct subsidies (including forms of tax credits for the consumer involved) are better policy tools for dealing with externalities than are subsidies and tax relief for broad classes of financial institutions. Suburban housing for middle and upper income groups is not, we think, the place where the externality problem is the most grave.

Alternative (d): If the Commission erred in its views of the future and if its recommendations are rejected, the consequences are obvious. We stay in today's world, with no great problems to concern us. True, financial markets would contain what to the academic scribbler are not inconsiderable amounts of monopoly power. True, there would be existing technological opportunities which could not

be realized in an optimal fashion. True, the policy tools for compensating for externalities are not ideal. Yet no grave problems appear.

In truth, the difficulty with this alternative is that the probability of its reflecting the realistic situation is essentially zero. Technology will change; tastes will change; externality conditions will change. The Commission's recommendations allow for this. In fact, as a matter of slight historical interest, at least, the Commission was so impressed with the changeable nature of the world – and the inadequacy of man to foresee the future – that there was discussion of explicitly recommending the periodic reinstitution of new Commissions on Financial Structure and Regulation.

Conclusions

Sketched broadly, these are the policy alternatives with respect to the Commission's *Report*. We believe the payoff from implementing the Commission's recommendations would be greatest if the future economic and technological conditions expected by the Commission actually occur. But, it is our opinion that given any reasonable forecast about inflation, interest rates, and technology available to financial institutions, the expected social benefits outweigh any possible costs which might occur as a result of the recommended restructuring of the deposit institutions.

To repeat, our contentions are not with fellow academicians and the few members of the financial community who would have proposed more radical reform. Our contentions are with those who, on the one hand, regard the *Report* as a revolutionary document which, if followed, would do great harm. On the other hand, our contentions are with others who regard the *Report* as a great give-away to financial institutions. It is neither. Those who fear the consequences of the *Report* on grounds of its doing social harm are, we suggest, putting their own interests in the preservation of the *status quo* above the social interest in change. This position is understandable, yet not one to which a commission might dedicate itself.

Less sympathetically, we suggest that those who see the *Report* as favoring existing financial interests have somehow failed to grasp how markets operate and the meaning of economic efficiency. This judgment is both harsh and potentially erroneous, we admit. Still, as we see it, it remains true that in the existing system very large numbers of financial institutions are of sizes far below those indicated by our knowledge of scale economies. It remains true that

financial institutions are denied access to markets they seek to serve and in which, if permitted, they would very probably raise the degree of competition. It remains true that, due to market imperfections and antiquated regulations, discrimination in the availability and price of finance and finance-related services abound. And it remains true that the world will change and that institutional responses are required.

It is our hope that somehow rational choices based on informed judgments can take place. We are far from sanguine that our hopes will be realized. But changes in public policy with respect to financial markets which occur in a crisis atmosphere seem to us to be far from ideal. Of the possible alternatives, those proposed by the Commission have much merit.