The Policy Proposals in the AEI Studies

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William Haraf and the American Enterprise Institute deserve praise for bringing together a group of eminent scholars to survey our knowledge of the financial services industry, to comment on its problems and prospects and to recommend changes. While we have not suffered from a dearth of proposals or remained unaware of the growing problems of the financial services industry, a comprehensive review by many of the leading scholars in the field is welcome.

In the past, we have relied on large projects, like the Commission on Money and Credit, or on government appointed committees like the famed Macmillan Committee or the Radcliffe Committee in England or the Aldrich or Hunt commissions in the United States. AEI has taken the useful step of bringing together scholars with long-standing interest and expertise in various aspects of the problem to propose a, more or less, compatible set of recommendations for financial reform. We are in their debt, not only for undertaking to provide this public good but for producing a set of generally thoughtful papers and many useful suggestions for reform.

I have been asked to comment on the policy recommendations and to provide an overview of the papers as a group. It is a formidable task. Many of the papers are rich in detail, full of references to historical experience and cover a wide range of topics. I must be selective.

The role of a discussant is to criticize and suggest improvements. My remarks should not be misinterpreted. This is a valuable set of papers that show a considerable amount of thought directed to major problems. There is a comprehensive set of recommendations and many additional suggestions in the individual papers. There are also differences of opinion. Kane and Folkerts-Landau and Mathieson have very different approaches to regulation. There are even disagreements, for example, about the desirability of having a lender of last resort or preserving deposit insurance, or even whether there should be any regulation of financial firms. These are not simple issues, and reasonable people can disagree. Indeed, they have in the AEI studies.

*Helpful comments were received from Marvin Goodfriend, George G. Kaufman and Robert King.
General Comments

Let me first consider three general issues that are relevant to several of the papers. These issues are, I believe, basic to an analysis of financial structure and proposals for reform.

First, are the issues of failure, financial fragility and banking crises. Anna Schwartz's paper touches on these issues when it presents comparative data on years of crisis and points out that, since 1866, there has not been a crisis in the U.K. banking system. None of the papers sets out to explain why banking crises were more common in the U.S. than in other countries.¹ Or, perhaps more important for understanding our current position, why are U.S. financial firms more prone to failure than financial firms in other developed countries? The U.S. economy is not subject to greater risk or more variability than many other countries. Inflation, disinflation and oil shocks contributed to the current problems of the U.S. financial system, but these shocks are common to many countries that do not have similar problems.

I stress this issue because I suspect that part of the differences between the U.S. and other countries is that the U.S. has experienced a massive failure of regulation. Two examples illustrate the point. Regulation Q was extended to all financial institutions in the mid 1960s and allowed to continue in effect throughout the 1970s despite the enormous cost imposed on the public and the negative effects on the safety and soundness of financial firms. John Weicher's paper reports an estimate of the costs of delaying the insolvency of many thrift institutions. He suggests that in 1983, all GAAP insolvent thrifts could have been closed at a cost of $2.5 to $6.5 billion. Today, he estimates the cost at $40 to $50 billion. Many of the losses, which may be someday shifted to the taxpayers, were avoidable if failed firms had been closed promptly.

If similar bad management, neglect and delay occurred in the private sector, it would properly be regarded as scandalous. Yet, the scandalous regulatory failures that maintained Regulation Q, substituted accounting

¹Schwartz suggests in passing that after 1866, the Bank of England accepted the role of lender of last resort.
gimmicks for responsible action to close insolvent banks and thrift institutions, bankrupted the FSLIC and some of the government credit agencies receive little attention from the Congress, the administration, the press and the AEI report.

Quis custet custodes? Perhaps, no one. I recommend that AEI undertake a study of the politics and economics of regulatory behavior as a companion to this study to help us understand how and why this failure occurred. Do we have in the thrift industry an example of capture theory — according to which the regulated become the regulators and use the agency for their own purposes? A proper reform proposal must go beyond a statement of the problem to an analysis of why the problems occurred, whether the problems arose as a result of regulatory failure and, if so, what changes in regulatory structure would provide incentives to prevent small problems from becoming large. In addition, we must be concerned about the incentives in the political and regulatory environment. Without such incentives proposals for reform are not likely to succeed.

Second, how do we get from where we are to where we want to be? The AEI study is not very clear about the problems of transition. Who pays the cost of closing the insolvent thrift institutions? John Weicher's paper suggests that the most likely outcome is that the costs will be borne by the taxpayers, but the study does not take a position on this issue. Should we instead treat the thrift industry, or the banking and thrift industries, as a risk class that must pay, ex post, for the mistakes or faults of members of the class. All 16 to 25 year old boys pay premiums to cover the cost imposed by the more reckless members of their age group. All buyers of health insurance pay premiums to cover the costs of treating cancer patients. These are ex ante differences. Here the failures are a fact. What is optimal in present circumstances? Should surviving banks and thrifts pay the costs of the failures? Or, should these costs be shifted to the taxpayers? The implication for the future are important. Imposing the costs on surviving banks and thrifts creates an incentive for improved future self regulation. Imposing the costs on the taxpayers continues business as usual, or as it has become.

Third, not much is said explicitly about the goal of public policy. Judgments about the proper degree of regulation or deregulation can be found
in several of the papers, but none offers a standard by which to decide whether there is too much or too little regulation. Much of the public discussion of risk either ignores the fact that there are risks inherent in nature and in institutional arrangements or tries to redistribute these risks by shifting the costs to others while retaining the benefits for one's own group.

The proper standard is to reduce the risks to the minimum inherent in nature and other institutional arrangements. It is not easy to apply this standard in practice. But it is a standard against which to judge whether there is too much or too little regulation, whether there are too many failures or, as in the past, perhaps too few. I believe that the contribution of these studies would have been increased if a risk standard for regulation had been proposed and some effort had been made to apply it by considering explicitly where there are problems of moral hazard, adverse selection or other types of risk that can be avoided by choice of institutional arrangement. Some individual studies implicitly use the proper standard, but it is far from uniform in the studies as a whole. A case in point is the suggestion in one of the papers to restore double liability on bank capital. I believe that this standard, if applied, would produce a sub-optimal supply of banking services.

Regulation of banking and finance is one of the oldest forms of regulation. It is unlikely that unregulated, competitive banking will be found to be economically efficient or attractive politically. A main reason is that information about safety and soundness is not a free good. An important issue here is whether the benefits that consumers receive from the use of banking services and the increased efficiency of the payments mechanism exceeds the cost of providing these services. Part of the cost is the risk of bank failures. Deposit insurance shifts this cost from the individual to the group and perhaps to society and provides incentives to increase the risk imposed on society by financial institutions with low or negative net worth.²

The AEI study correctly emphasizes the roles of competition between

²As is well known, such institutions face asymmetric risks and returns. Losses are borne by the insurer; gains go to the owners. Hence the owners take excessive risk
institutions and of new entry in achieving a social optimum. The study is
less clear about the means of lowering the risk of a near universal system of
deposit banking. The study goes part of the way toward accepting a
comprehensive system of voluntary deposit insurance and reliance on owners of
capital and subordinated debt, proposed in the Benston and Kaufman paper. The
study does not emphasize a key feature of the Benston - Kaufman argument:
banks decide whether they choose to offer deposit insurance. If a bank joins
the deposit insurance system, management must maintain capital. If capital
falls below some positive minimum, the proposal allows the insurer to close
the bank if the owners do not provide additional capital.

I believe the recommendations would be improved if the explicit
recommendations of the Benston and Kaufman study were made part of the general
recommendations with some amendments or extensions. Deposit insurance does
not have to shift from 100% to zero at $100,000. More thought might be given
to determining the point at which individuals or firms would co-insure. More
attention could be given to determining the optimal failure rate. Much more
attention should be given to the difficult problems of valuing consumer loans
or small business loans that are behind in their payments. I believe that
success or failure in the business of being a banker depends on how these
judgments are made and that it is misleading to suggest that accountants can
make the judgments for us. Nor do I believe much will be gained from having
small banks issue debentures. Market valuation requires that the debentures
be traded with sufficient frequency.

The Specific Recommendations

I have drifted from general issues into concern for a specific proposal
to balance social and private interest in the regulation of financial
institutions. Let me return to Haraf's paper and the specific recommendations
of the study before commenting further on some specific proposals.

The study locates the current problems of the banking and financial

3I note, however, that there are potential problems of dissident
stockholders and of the protection of minority stockholders in the event of
recapitalization.
industry in four main areas. These are: (1) restrictions on competition; (2) mismanagement of deposit insurance, particularly the improper incentives in the deposit insurance system and its relation to capital requirements; (3) monetary policy, particularly the policies of persistent inflation and rapid disinflation; and (4) the mistaken attempts to use the financial system to subsidize housing, homeowners and, perhaps, homebuilders. Two additional areas are discussed, international coordination of regulation and the system for transferring payments and overdrafts.

I have little to say about the last two topics. The basic thrust of the report might have suggested more consideration be given to privatizing wire transfers as a desirable end and a means of eliminating potential costs of defaults to the taxpayers. On international coordination of regulation, I agree with the approach taken. The record of financial regulators in the U.S. is a brief against an international agreement to coordinate regulation. Before proceeding to international regulation, it would be interesting to see the results of a study of the net costs or benefits of the banking and financial regulations of the past fifty years. It would also be useful to consider why uniform regulation of banking and finance is more appropriate or socially desirable than uniform, international regulation of the automobile industry, the chemical industry, electric utilities or other industries where social costs arise in the production process. Before opting for a regulatory cartel, one should recognize that, recently, several of the states acted as a constructive force pushing the U.S. Congress toward financial deregulation. And, one should not forget that it was Comptroller Saxon in the 1960s who began or encouraged the deregulation process a the national level.

Haraf's recommendations to reform the financial system are steps in the right direction. In effect, he asks how market forces can be used to foster a responsible, competitive financial system. In this respect, the proposals are not only an improvement over the present arrangements but over many alternative proposals that place less reliance on incentives and market forces to regulate or that seek, perversely in my view, to set out a rigid structure within which firms must operate.

An additional, commendable feature of the AEI study and Haraf's paper is the recognition of the importance of stable, predictable prices. I would prefer to see that phrased as reducing variability to the minimum inherent in
nature and institutional arrangements and, I believe, emphasis should be on the stability of expected prices, but those are small points in this context. The main point is the implied recognition that many of the problems in real estate, farm lending, federal credit agencies and international debt are the heritage of policies of first chasing the evanescent Phillips curve followed by rapid disinflation.

Let me mention a few places where I have disagreements with some of the papers. I will center on three issues. First is the role of lender of last resort and its relation to deposit insurance. Second is the financing of housing. Third is the issue of political incentives. I have written on two issues earlier, so I will make explicit the predilections that I bring to these issues.

Many years ago, I pointed out that the public provisions of deposit insurance was based on a confusion between individual bank failure and system failure (Meltzer 1967). I proposed private deposit insurance and a public lender of last resort. Later, I urged that the public lender of last resort follow a rule similar but not identical to Bagehot's famous rule (Meltzer, 1986). I want the lender to be required to lend always -- that borrowing be a right, not a privilege, for any bank offering to discount standard banking assets at a penalty rate. Even a small penalty rate would assure that the lender of last resort would do no lending except in a severe banking crisis when (or if) markets do not function. As in the Goodfriend-King paper, central bank operations would be limited to open market operations. Lending activity would be limited to times when the market malfunctions, specifically when there is a premium on cash and no one wishes to lend. If this type of malfunction does not occur, central bank lending will remain at zero.

While I agree with the general position taken by Goodfriend and King, I think they are wrong in their claim that supervision and regulation are a necessary part of central bank lending to financial institutions. Their discussion applies much more to publicly supplied deposit insurance than to a properly restricted lender of last resort. A rule that all loans are at a penalty is a contingent rule that separates borrowers into those who do not borrow and those who have acceptable collateral that cannot be sold in the
market at less of a sacrifice than the central bank penalty. A rule of this kind does not require regulation or supervision.

The reason for insisting on retaining the lender of last resort function is to avoid catastrophes like 1931-33 when the lender refused to lend. Having penalty rate loans as an option means that banks have access to base money even if the central bank repeats its major error of the 1930s. It is useful to recall, in this regard, that Bagehot (1873) did not criticize the Bank of England for failing to lend. He criticized it for allowing panics to spread before they decided to lend. Bagehot's main criticism is not that the Bank of England failed to act. It is that uncertainty and panic increased because no one knew in advance what the Bank would do. The solution he proposed was pre-commitment to a rule, in fact, to his rule. As Anna Schwartz points out, after the Bank accepted responsibility as lender of last resort, there were no further panics. These were bank failures.

In our times, the rule provides an additional safeguard. Central banks and governments are prone to too much rather than too little activism. A rule setting a penalty rate is helpful for this problem also.

How does my earlier proposal for private deposit insurance compare to the Benston-Kaufman proposal? Both face at least one common problem -- valuing the banks assets when, as is true of many assets, these assets are not traded. The Benston-Kaufman proposal avoids two problems of private deposit insurance: (1) there is no responsibility for the auditor to make judgments about the risks undertaken by banks with sufficient capital that accept sizeable interest rate risk; and (2) there would be no problem of cancellation in periods of turbulence, as recently occurred with directors' and officers' insurance. On the other side, Benston and Kaufman rely on the regulators to take charge of problem banks. Why would the regulators under their system function more effectively than current regulators? Would they find ways to redefine capital, obfuscate and delay?

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4The penalty rate should float with the market rate. If there is no private demand, so the market does not function, there must be a rule fixing the penalty in relation to market rates in the recent past. This is a detail. The main point is the importance of a rule to prevent non-feasance by the central bank.
John Weicher's paper on housing finance has much interesting material. Weicher reaches the right conclusion -- eliminate the government's mortgage operations. He errs, I believe, on two main points.

First, he claims that the social preference for housing can no longer be secured by financing arrangements. Subsidy elements aside, this has always been true (Meltzer, 1974). Selling a bond and issuing a mortgage might change the way in which the public borrows, but mortgages are nominal instruments and housing is a real asset. Supplying more mortgages does not create more housing, and I know of no evidence that it ever has. This issue is important because protection of housing has long been an excuse for wrong-headed financial policies offered to assist housing.

Second, I am skeptical about his argument that specialized mortgage lenders will disappear in the future. Costs of information are important in appraising or valuing real property, so specialized entities arise to fulfill these functions. A more likely development is that the specialized lenders will be part of a diversified institution as suggested, indirectly, in Franklin Edwards' paper.

Finally, I want to comment briefly on the political economy of reform. Only Ed Kane's paper recognizes that regulators do not act solely to achieve a social optimum. Industries, unions, regulators and other parties have interests that may include, but are not limited to, social welfare or economic efficiency. Haraf accepts many of Kane's strictures when discussing international regulation, but neither he, nor the others, see the relevance of what Kane discusses for other reform proposals. If this useful study is to be more than another volume on the shelf, the authors must devote more attention to the political economy aspects of regulatory reform. Most financial reform of the past decade have come from the piecemeal actions of the states, not from comprehensive reform. It is not an accident and not a consequence of a shortage of proposals.
References


