Financial Services & E-Commerce

4th Annual Financial Services Conference

*Remarks by Hon. Peter R. Fisher**

HON. PETER FISHER: Continuous improvement in the efficiency with which we convert savings into investment is the preeminent objective that we, as a society, have for our financial intermediaries. We want both to minimize the potential loss of savings to individuals and society, and to maximize real risk-adjusted returns on investment.

For the last century and a half, we have sought to minimize the potential loss of savings by accepting a role for the federal government in promoting what in the late 19th Century we would have called monetary stability, but by the end of the 20th Century, we came to call financial stability.

In the last 20 years, we have begun to strip away the obsolete segmentation that the federal government imposed on our financial system, to shore up the soundness of financial intermediaries. That compartmentalized regulatory scheme imposed too great a constraint on financial intermediation. We have begun to dismantle these rigid functional and geographic barriers, but we have not yet fully accepted the supervisory and regulatory consequences of our loss of faith in the efficacy of those barriers.

We need now to follow through on the Congress' commitment to open up our financial services industry by focusing our regulatory efforts on promoting competition among all intermediaries. We are still concerned for financial stability, but in a more competitive more dynamic financial system, we must pursue this in a different way.

Supervisors of financial intermediaries need to be a little less concerned with preventing every bad outcome, and instead, should concentrate on improving the overall resilience of our financial system by thinking of it as a system. In the language of statistics, and distributions, and portfolio theory, supervisors should minimize negative Tail Outcomes by striving to maximize positive Tail Outcomes.

Now Adam Smith praised the invisible hand of individual incentive, but he was even more passionate in his animus toward the visible hand of government. His hostility was not to the exercise of government power per se, but rather to its likely abuse by men of commerce, particularly by the intermediaries or dealers seeking to limit their competition or gain privilege.

"The interest of the dealers", Smith wrote, "is always in some respect different from, and even opposite to that of the public. To widen the market and to narrow the competition is always in the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public, but to narrow the competition must always be against it, and can serve only to enable the dealers by raising their profits above what they would naturally be, to levy for their own benefit an absurd tax upon the rest of their fellow citizens.

The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted until after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention."

Adam Smith's concern was mercantilism. Today, however, he would recognize the competition distorting consequences of all manner of subsidy, preference and guarantee, as well as the problems of agency capture and regulatory arbitrage.

Moreover, for most of the last two centuries in banking and finance, we tended to compound the general problem of competition distorting government interventions by the very means we use to protect the stability of financial intermediaries.

Through the sovereign's power to charter, we carved up the pathways of financial intermediation, allocating different sets of risks and returns as franchises for different forms of intermediation, deposit taking and loan making, investment underwriting, insurance underwriting, brokering and so forth. Holding less than the total set of available risks and returns from financial intermediation, any one form is necessarily less robust, less stable than the full set. By itself, each is prone to crisis in the event that its particular form of arbitrage suffers an abrupt or prolonged period of below average returns.

Each chartering authority reasonably sees its mission, however, as preserving the safety and soundness of its particular set of charges. To counterbalance their vulnerability to crisis, the chartering authority is tempted to pad the revenues of its franchisees by limiting the competition they face, or by providing special privileges not available to competitors.

These added returns, however, do not promote the efficiency with which society convert savings into investment. They represent a toll, Smith's absurd tax. Nor are the returns so extracted from our savings likely to make that particular form of intermediation any more robust in the long run.

We Americans made matters even worse with the misguided thought reflected in Glass Stiegel that the set of risks and returns called commercial banking could be made stronger by a rigid separation from the rest of the intermediation pathways, and particularly, from the set of risks and returns called investment banking.

In the late 1980s, starting with the regulatory reforms of the Federal Reserve Board, and eventually with the passage of the Gramm-Leach-Bliley Act in 1999, we began deconstructing the forced compartmentalization of our financial services industry. We need now to see this process through by clearing out the cobwebs of regulatory arbitrage that restrict which firms can provide which financial services.

We have and want to retain different forms of financial intermediation, but we also want to encourage vigorous competition at the frontiers among these forums, and the firms that provide them. Our system of financial rule writing, and particularly the licensing and chartering of financial service providers needs to respect this dialectic, promoting alternative forms of intermediation and vigorous competition among them. Limitations on who can compete, and how they can compete should be viewed wit the most suspicious attention. In a more competitive, more rough-and-tumble financial environment, we may have more, not less concern for financial stability for minimizing the potential loss of savings for individuals and society.

The supervision of financial intermediaries, the hands-on job of looking over the shoulders of individual financial institutions, originates with a desire to avoid some set of bad outcomes, bank failures, depositor losses, fraud, or some other form of consumer or social loss. The supervisory challenge is to limit these negative Tail Outcomes. To do so while promoting competition and efficiency, however, requires that we recognize that individual failures are part of an overall system that produces both negative and positive outcomes.

When we adopt this portfolio viewpoint, we see that the society as a whole is likely to benefit the most through the improvement of overall performance. We can do that best when we strive to maximize positive Tail Outcomes across the whole financial system. Snuffing out every bad outcome, that is stifling competition cannot be the way to spur the whole system to best performance.

Indeed at both the level of systemic stability and for any particular products or sales practices, the only compelling case for financial supervision is as a means of more rapidly disseminating best practice than would otherwise be the case, in order both to minimize the likelihood of bad outcomes, and to improve medium and mode outcomes for society.

There are two consequences of thinking of financial supervision in these terms. First, when we think of financial supervision in the context of the range of positive and negative outcomes that a particular form of financial intermediation produces, we better understand the systemic role of the supervisor. Over the extended time horizon and the total portfolio of intermediaries of concern to the supervisor, minimizing the loss of savings will be a consequence of, and not at odds with the striving for the positive Tail Outcomes that reflect convergence on best practice, and serve to maximize real risk-adjusted returns.

Second, in order to be an effective means of redistributing best practice, the supervisor needs to know what best practice is. This requires real knowledge and expertise about the risk and rewards of the particular businesses to be supervised. In the absence of this knowledge and expertise, the supervisor is unlikely to be able to promote best practice, and is more likely only to add to the cost of financial intermediation; and thereby, regrettably diminish the overall efficiency with which our savings are converted into investment.

At the practical level, in order to know best practice, supervisors need to be specialized by lines of business and sets of risks. If we can focus the role of the federal government on the twin tasks of expanding competition among the providers of financial services, and of channeling supervisory resources to serve as a means of redistributing best practice, we will be moving in the right direction.

Thank you very much. I'd be happy to answer your questions. All right. Or you can serve dessert if you'd like.

MR. COCHRAN: Can you talk about how that applies to the case of a proposal for an optional Federal Insurance Charter, and the real estate broker banking rules?

HON. PETER FISHER: Clearly in both cases, more competition is better than less, and I'll hold out both those issues to the question of how are they help moving us in the direction of getting toward more, not less competition.

I think the Insurance Charter question is one that I feel rather strongly about, that if there's going to be the advent of an entirely new edifice of federal financial supervision, someone had better explain to me how it's going to make the problems that I'm concerned about lessened, rather than increase regulatory arbitrage and barriers, so I don't take it at face value that simply creating a Federal Charter will lessen those. I think it remains to be seen whether the ideas that come forward for how we could go about that will actually serve to move us in the direction of more coherence in the federal role in rule writing for financial services, and I'll leave it at that.

MR. ELY: Peter, if I remember correctly, your talk today is building on your talk a few weeks ago at the Exchequer Club, and I have a question that follows up on Andy's question. It has to do with, shall we say the different philosophies towards safety and soundness that we see that have evolved in banking, in securities and insurance. And it seems to me that this comes to the fore as we talk about the optional Federal Insurance Charter, that there are beliefs that because these are significantly different businesses in some ways, there have to be differences in regulatory approach.

For instance, in banks versus property and casualty insurance companies, the banks would primarily worry about what the value is of assets. Over in the P&C business, you not only have concerns about value of assets, but also very significant issues, much more significant issues in terms of how you estimate what liabilities are, again particularly when you get into Long Tail Liability-type insurance.

In the securities business, there's been a much more rigorous mark to market routine than we have traditionally had in banking.

How do you propose that these different philosophies, leaving aside the agencies, but the different philosophies get melded together, or do you envision the world where you still have different philosophies about safety and soundness as it applies to the insurance business, to the securities business, and to the banking business?

HON. PETER FISHER: I don't think it's at the level of philosophy. That's a great question, Bert, but I don't think it's at the level of philosophy. When I say I think we're going to have, we have, and we want to have different forms of intermediation, I think we need to preserve some core differences in ways that we intermediate risks and credit across time, and across parties, so I'm a kind of securities market guy, so I want to be the first to say, I think the mark to market discipline is a terrific one, but I wouldn't want to live in a society in which every form of financial intermediation was subjected to that. That's what I mean by we want to preserve different forms of financial intermediation.

Now I think that, and you can actually get to a rather refined question very quickly. The greater defenders of mark to market say well, you've got to mark to market. And you say oh, really? What about all that stuff you mark to model? Oh, well that's different. Well, you can right away inside the mark to market model. They're marking to model, which is a complicated way of saying to a bunch of assumptions we have about the nature of our form of intermediation, and when we may have to pay the piper. So I think we want there to be different forms of intermediation, intermediation across time, marking everything to market gives you a certain kind of crispness to the discipline.

We have to preserve that, but I think as I refer to it, the frontiers, I think we really know it when we see it, when we have two products that are identical for the consumer. The consumer is getting two products. They serve the same purpose. They provide either a borrowing or a savings vehicle, and they get hugely disparate regulatory treatment from a capital end, or on some other end, and now we're just going to run a regulatory arbitrage until we see how long society can stand it. And so, I think that I really, when I say it's about a dialectic process, I really, really mean that.

Forgive me. At the New York Fed they used to tell me please don't use that word. It's really eggheadish, but it really is what I mean. We want to try to preserve these core forms of intermediation because as a society, we don't want to put all our eggs in one basket. And we want that with the frontiers to create a rule writing process that says "wait a minute, we know here at the frontier you guys are doing the same thing, and we've got to sort this out, and figure out if there's going to be one rule for this." Otherwise, we're just running an arbitrage.

So I think there are ways, as I spelled out in my speech a couple of weeks ago, not at the Exchequer Club but at Brooklyn Law School, about how we could think about a rule writing mechanism that held people to this higher standard of like products and like services should get a like treatment while they pursue maintaining core disciplines on the different forms of intermediation. I think we can imagine a number of different ways of doing that, but where we are is, we're hiding ourselves. We're not confronting this issue, and we're leaving, like I say, the cobwebs of regulatory arbitrage in place.

That's one way of thinking about it, and I'm really not being coy. I'm trying to be exquisitely clear about what I think the objectives are. And I think I've thought about them, and I've observed capital markets and our financial system for a while. I think that's my expertise.

The right way of slicing and dicing the bureaucracy is not my expertise, but I'd like to hear ideas about the right way to serve these objectives in the long run. I mean, the different ways we could organize a mere bureaucracy to serve society's purposes better.

MR. ROGER: What's in it for us?

HON. PETER FISHER: No, no, that's fine. Who's us?

MR. ROGER: Us being the Neanderthal banking lobbyists. What's in it for us?

HON. PETER FISHER: Well, that's a good B-.

MR. ROGER: I mean, arbitrage is good sometimes.

HON. PETER FISHER: No, it's not. Let me be clear, you're on the wrong side of Adam Smith. Let me be clear.

MR. ROGER: I'm asking the question B-.

MR. VERDIER: He's patiently on the wrong side of the B-.

HON. PETER FISHER: Yeah. I think what's in it for you is the point at which the people who are paying the freight for you, get tired of paying for lobbyist for each of their subsidiaries to fight each other. And the question is, are you going to be the first to go, the most neanderthal, or the last to go? Because that process is underway.

The people at the top of the major financial services firms in America are tired of paying for phalanx of lobbyists to do war with each other on behalf of their different subsidiaries. And that's what their interest is in, is in reducing that as a business obstacle.

You think of yourself as a profit center, but when you step back, and as I look at it for society's interests, and for the larger companies who have lots of different products and are big enough now to be reasonable proxies for a broad national market, you're running an obstacle course for them on trying to get products out there that meet the broader demand, so I think that's a pretty big interest on your part. And I think it's certainly in society's interest, and as long as we're being candid about who's on society's side and who's not, I'll take the fight any day, but on the terms that you're trying to increase the absurd tax that Adam Smith was complaining about, and I'm trying to maximize the return on savings that the American people get. I'll take that debate any day. Any forum you want to have it, I'll take it.

MR. FEINBERG: The buzz word that you're alluding to is what Demming would call B- did call sub-optimization, so that it's a little obvious up here, we're trying to abrogate and often successfully an optimal solution at a very low level, and you're talking about how to achieve something better at the macro level.

The buzz words that are being heard around here are transparency, independence and accountability, but these don't apply to the fragmented segments of the financial services industry, or maybe the larger communications industry. Ultimately, would you think that it might be more difficult for those who are trying to carve out these protected areas and levy absurd taxes, more difficult for them to hide?

HON. PETER FISHER: Yes. I think that that, in fact, is part of what has been happening in our capital markets for the last two or three years. And I think that independent of our regulatory structure and the sort of B-, and I want to be clear, I'm referring to the regulatory, not the statutory structure in my remarks - I think part of what's going on is that the opportunities for arbitrage out in markets across the entire capital structure are putting pressure on firms that are too narrow in the arbitrage they're running. And so part of it B- there are lots of other contributors, I want to be clear, to what we've seen in asset markets over the last two or three years. But I think that that is part of what's going on out there on the market side, as well as say on the regulatory side. Absolutely.

MR. HYLAND: As a practical matter, when would the Bush Administration be B-.

HON. PETER FISHER: I'll repeat the question. The question is when might the Bush Administration have a proposal on this? And I don't have any idea. I don't have any concept of proposal. There's much too little consensus on this topic. There's much too much B- what I've been saying for the last 18 months is too many people think that Gramm-Leach-Bliley was Act Four of this drama. I think it was Act One. I think there are two or three more acts to go. We need more of a critical mass of consensus that this is B- that there is a lot more to go in this drama, and we need more consensus. It's premature, not enough people in this country understand how embarrassing we look from outside this country, how are financial regulatory landscape looks like the Keystone Cops, from London, or Frankfurt, or Singapore. And that's something that is a tax on us as a society, given our need for imported capital, I would point out. So I think we need a little more sense of urgency on the part of everyone before it would be fruitful to have a particular proposal.

MR. ELY: Are you envisioning or suggesting some kind of new federal entity with rule making authority that, in effect, could preempt individual agencies or individual groups of agencies, let's say like the banking regulators or insurance regulators, much the same way that the federal government can preempt the states and does regularly? Or are you envisioning something that's like the UK's FSA? I'm trying to figure out how this actually translates into some kind of bureaucratic reality.

HON. PETER FISHER: Certainly more of the former than the latter, but I don't — what you've just outlined is an intriguing way to think about it. I think that given my emphasis on the supervisory side, and as I've been clear before in remarks, I don't see any benefit from rolling up the supervisory component into a single agency.

MR. ELY: Your concern is with the rules.

HON. PETER FISHER: My concern is with the rules, so I think the FSA model that's been adopted in some countries, they're sort of putting it all in one place, doesn't do anything for me. It actually gets me off on the wrong foot, given how important I think the supervisory side is. I just — there's no particular reason why you're going to get faster to the right mix of expertise and discipline putting them all under one umbrella. There's just nothing there for me on that side.

On the rule writing side, you clearly get to a consciousness that there's one rule writer who has to think about the arbitrage at the frontiers, the warfare at the frontiers, but I don't have a disposition on the right bureaucratic forum. I really don't, but I want to be clear about the objective pro competition; that's, how could we invent system that would be pro competitive, much more pro competitive than we're used to, because habits — the first economist I worked for taught me wonderfully that habit is the most underestimated variable in human behavior, and therefore, in economic models. And we changed - Gramm-Leach-Bliley was passed into law just three years ago - the habits of the prior 150 years haven't all disappeared, and how we think about charters, and who has what power, and who does what, and who can do what. We've got to strip those away, and that's why I'm looking for an engine, a pro competitive engine as an overlay somehow or other on our rule writing process.

MS. ANDREWS: If your philosophy of enhancing competition were taken down to let's say OTS and OCC, do those agencies have, if they were to adopt that philosophy, a duty to look at the impact of their regulation on the broader financial services market, which the banks and the savings institutions compete. And I use, for example, the mortgage lending industry where banks compete with non-state regulated lenders. So would the agencies have a duty to look beyond their own marketplace, their own membership, if you will?

HON. PETER FISHER: Well, that's the right thrust, but I don't know whether the right bureaucratic forum is to impose that duty on them, or have a right of appeal somewhere else if you think there's an arbitrage or some super rule writer over them. I don't know what mechanism, but that's a great example of all the different capital treatments we get throughout the whole mortgage pipeline. There are all kinds of different capital treatments all over the place, and we probably ought to think about, as a society, whether we want to have that amount of arbitrage or a little less going on.

MS. ANDREWS: I want to use a specific example with the Alternative Mortgage Parity Act, where the OTS has issued a rule that is going to eliminate the preemption that was given to alternative mortgage lenders in a couple of areas, prepayment penalties and, I forgot the other one. But anyway, so that's an example where an action of an agency is actually hurting competition in a market in which the savings institutions are actually given a competitive advantage against the state's mortgage lenders.

HON. PETER FISHER: I'm not familiar with the particulars right there, but that's the sort of issue I'd want to see a mechanism to be squeezing out over time.

MR. DOUGLAS: In terms of enhancing competition and sort of artificial barriers, do you have any thoughts on the ownership of banks in terms of the area that was driven or created by the Bank Holding Company Act, in terms of the types of entities that may own and operate commercial banks?

HON. PETER FISHER: I haven't thought of it as a — I mean, we have restrictions on all kinds of intermediaries, not just banks and bank holding companies as to who can own what, going to fitness, if you will. And obviously, some of those are entirely appropriate and some of those are masks for limiting competition.

I'm not familiar with the current state of play and how those rules are being treated for banks. I'm a little more concerned. I'll give you B- when I look at the problem of someone taking a charter, some equity holder who owns a financial institution. We'll use a bank or an S&L for the moment, and they actually have a broader range of returns. And they try to take that charter and have it take on just a particular slice of risk in returns, and they run a high risk strategy. That's a big problem, because then they're using that charter as part of a strategy of getting returns in their total portfolio, but in my frame of reference, we know that narrow arbitrage strategy may blow up under certain conditions. And it may have worked for them as portfolio holders, but it doesn't really work given our interest in financial stability and federal safety.

MR. DOUGLAS: So that becomes an issue of how you supervise or put the parameters around the box that we call a bank.

HON. PETER FISHER: Yeah, it does. I feel the same way about any charter.

MR. DOUGLAS: Right. But in terms of say, just a hypothetical out of thin air, a Wal-Mart acquiring a depository institution, is there any sort of philosophical basis for saying yes or not to that?

HON. PETER FISHER: Just never thought about that question.

MR. PEMBERTON: I've got to preface, I'm a lawyer. I'm not an economist, and I don't even balance my checkbook. So the premise that you put forth that we don't have the competition, I guess I don't understand fully why that would be. It seems like a perverse sense, we have exactly the kind of systematics that would have envisioned where we have these competing forums and charters. And even in the last 20 years, you know, people used to put money in banks and then mutual funds became sort of an option. A lot of individuals now have mutual funds, and you know, banks want to get B- you know, they want fee income, so they start offering mutual funds, and they find other services they want to offer.

I mean, there is some convergence. I mean, insurance companies want to cross into banking, and I just wonder really, don't we have a competitive system? I mean, it may be complicated externally, but it seems to be competitive. And whether insurance executives really want to be in banking, I don't know. I mean, somebody who may be a good insurance customer may not be the best banking customer, and vice versa. And I just wonder about that premise.

HON. PETER FISHER: There's no doubt that we have among the most robustly competitive financial services industries in the world. Nothing I've said today should take anything away from that. I think you were here earlier when we had a question from over here, what's in it for us? Arbitrage is very profitable. I offer that. I think there is yet some evidence that the system is not as efficient and pro competitive as it might be. And I think, you know, there's almost any topic, you could open almost any page of the relevant volumes of U.S. Code or various regs, and almost randomly put your finger on a page, and I bet you could come up with margining rules and how different they are in different products. So I take your point. We have a wonderfully competitive system.

I think that our regulatory process to pride itself on how archaic and out-of-date it is, and how verging on irrelevant it is for where the industry is going, is not something that would come very easily to an Under Secretary for Domestic Finance.

* Hon. Peter R. Fisher is the Under Secretary for Domestic Finance, United States Department of the Treasury. His remarks made up the luncheon address of the Federalist Society's 4th Annual Financial Services Conference on October 11, 2002 at the Rayburn House Office Building.