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Commentary: *The Financial System and Economic Performance*

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Robert Merton's article gives an excellent and successful overview of many topics included in the area of international competitiveness in financial services. I like the way he focused on three particular issues: financial innovation, junk bonds, and loan guarantees. He develops these issues with the use of simple examples—abstract examples, to be sure—but examples that highlight the problems at hand.

I completely agree with his conclusion on loan guarantees—that they are potentially a big and costly problem for the government. In fact, in the President's budget submitted earlier this year, there was extensive discussion of loan guarantee issues and how we might control the risks and their costs. We discussed not only the issues associated with deposit insurance that are highlighted by Merton in his article but also issues related to guarantees in the housing area, the student loan area, and so on.

It would be possible in principle to score these loan guarantees on the budget the way that Merton suggests, and this is one possibility for reform that is rightfully being considered. Another possibility is simply to put outright limits on the extension of loan guarantees. These are possibilities that I support wholeheartedly, as does the Administration.

The issues that I would like to focus on here are the other two that Merton develops—financial innovation in general and a particular type of financial innovation, junk bonds. I will describe how I see these innovations evolving and affecting the financial intermediary sector, and discuss some of their implications for possible reform activity.

It seems to me that most of the recent developments in financial innovation and their effect on the financial system are best thought of in terms of one single trend—the trend toward direct financing as distinct from intermediated financing. Nonfinancial corporate paper outstanding has grown at an 18 percent rate since 1972, for example, compared to growth of 10 percent for commercial and industrial loans. Over this same period of time, the share of bank loans in short-term and intermediate-term credit has shrunk from about 80 percent to 50 percent. This reflects the predominant trend toward direct loans as distinct from intermediated credit. About a third of all mortgage activity now takes place through mortgage-backed securities. Junk bonds, which are discussed in Merton's article, are another aspect of the ability for many firms, in addition to the very large firms, to obtain credit without going through financial intermediaries.

These developments reflect technological improvement, both in the information area and the communication area. Banks and banking-type institutions do not have as much of a comparative advantage as they once had in developing the kind of information they need to generate loans. This is, perhaps, one of the main reasons why bank profitability has declined throughout the 1980s. This decline is noticeable in almost all the figures on bank performances.

To be sure, financial institutions are adapting to these changes in their circumstances. New lines of business are being developed at the financial intermediaries. Standby letters of credit, for example—through which banks actually provide a credit analysis even though they are not providing the funds—separate the credit analysis from the funding. Standby letters of credit have grown by 26 percent per year through the 1980s, a substantial increase in this activity.

This is not the only new line of business that banks have developed. If we measure the trend away from direct bank lending by looking at earnings generated by fees as distinct from interest earnings, fees relative to interest earnings have increased substantially during the 1980s. These financial innovations have had substantial effects on financial intermediaries, on nonbank firms as well as on banks.

For an industry, or for any firm in the industry, to adapt to these kinds of innovations, it is important for the firms, in this case the banks, to have flexibility to make changes. In industries that are not heavily regulated, adaptation to change is relatively easy. In industries that are extensively regulated, adaptation can be much more difficult. I think this is probably the best way to think about the greatest challenge we face with respect to regulatory policy in the financial sector of the economy.

Deposit insurance probably has slowed the adaptation of banks by permitting the continuation of less profitable lines of activity than otherwise would have occurred. The ability to continue doing business in relatively unprofitable areas has slowed down the speed with which banks and nonbank financial institutions have adapted to change. The challenge in thinking about regulation is to find ways for banks to adapt to these changes.

Some possibilities worth mentioning are referred to by Merton in his article. The notion of functional regulation as distinct from institutional regulation is one way to think about providing flexibility for banks to change. Developing risk-based capital requirements as a way to allow institutions to choose among types of financial activities is another being discussed actively. Risk-based deposit insurance would offer still another way for financial institutions to choose among lines of activity that they want to pursue, with differences in risks reflected by differences in costs to the firms involved.

There are, in fact, some features of the Financial Institution Reform, Recovery and Enforcement Act (FIRREA) that permit financial firms to opt for particular activities. Separately capitalized subsidiaries of S&Ls, for example, can go into a broader range of activities, as long as these activities are not supported by insured deposits. This is an example of the application of the risk-based deposit insurance premiums idea.

Finally, in terms of flexibility, I think we need to re-examine whether we should continue to maintain the distinction between investment banking and commercial banking, the so-called Glass-Steagall regulation. Of course, a great deal of relaxation of this distinction has occurred already, but we are actively considering that more could be permitted. Any kind of relaxation should certainly take into account the potential for

uneconomic diversification made possible by the continuation of deposit insurance. The issues of deposit insurance and possible revisions of Glass-Steagall need to both be considered together in an effort to reach the goal of more flexibility in regulation of financial institutions.

The appropriate way to think about the activities of financial institutions that Merton so nicely illustrates with examples in his article is, I believe, to consider how more flexibility for adaptation to change could be introduced into our regulatory policy. One approach is to allow financial institutions a greater choice in opting for more risky or less risky activities, as long as the risks are borne by the firms and not transferred to taxpayers. Firms would then be better able to adapt to the changing financial environment and continue to operate profitably in areas where they can provide financial services efficiently.