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Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation: Discussion
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DISCUSSION

A. W. SAMETZ*: Kane's analysis of the post-1960's causes of the decreasing effectiveness of banking regulation is first rate, and his framework of the "regulatory dialectic" is insightful and useful towards explaining the 1970's surge of de-regulation. However, I would add to the list of basic causes and would consider their durability. And more importantly, I find Kane's "dialectic" far less useful towards explaining or predicting the re-regulation phase of the regulatory cycle.

It should also be noted that when the unshackling process is celebrated as well as analyzed, issues of tone and emphasis are introduced that are likely to put off the very "non-believers" one may wish to reach. For example, there are, of course, costs of de-regulation as well as benefits of regulation; why neglect them? And not all bankers are heroic "can-doers" to be contrasted to cloddish regulatory "bureaucrats" even during a period of de-regulatory euphoria.

Kane's excellent overview of the rapidly changing financial environment of the last two decades would gain from the explicit addition of the factor of the increased financial and business risk that has accompanied the primary dynamos of the increasing rate and unpredictability of inflation and rapid change in financial technology. Furthermore, the addition of the factor of increased internationalization of both the economy and its finance would further strengthen Kane's argument that traditional domestic regulatory protectionism has been undermined by extensive change in the financial environment given the superior adaptability of the regulatees.

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However, explicit consideration of the risks that accompany increased financial flexibility and efficiency remind us of potential re-regulatory aspects that are not stressed in Kane's regulatory dialectic. For example the decreased financial regulation of the last decade has been accompanied by increased *economic* regulation and intervention; and financial history suggests that the re-regulatory process in finance (should it occur) is likely to be precautionary in form rather than protectionist, if the increased riskiness leads to impairment of "soundness and stability." In short, there are costs of (financial) deregulation and benefits of (precautionary) re-regulation.

Re-regulation trends may not be simply efforts to redesign old protectionist regulations to maintain or restore the status quo of particular financial institutions. (I do not consider increasing consumer/community fair play regulations as substitutes for decreasing regulation of product and geographic lines.) And net financial de-regulation may lead to increased protectionist regulation in economic sectors.

What I am suggesting is that, if regulatory models are to be useful in public policy making, they should include long run as well as short run impacts, and economy-wide as well as sectoral impacts. Moreover, equitable treatment of owners of depository institutions as well as of depositors and borrowers need be considered.

Consider the electronic fund transfer process which Kane treats perceptively as a technological development that was speeded up by regulatory restrictions and resulted in undermining those restrictions. It is also true that EFT may lead to increased regulation in other directions as a result of privacy and concentration issues. In the long run, EFT may lead to precautionary re-regulation of a universal banking system, rather than protectionist re-regulation of a specialized or boutique form of financial structure. Specialization by free choice is likely, after all, to be less than when mandated by law.

Allow for the possibility that we may be on the verge of an era of regulatory innovation. After all, the technological revolution in information handling also expands regulatory technique, and if the inflationary process leads to severe financial crises and economic dislocation, the stage may be set for novel forms of precautionary or prudential regulation. In other words, the very same factors that induced financial de-regulation may, under certain (not implausible) conditions, induce re-regulation of a nonroutine sort.

Private entrepreneurs may adapt more efficiently than public bureaucrats to the rules of the game as Kane hypothesizes; but the regulatory process also involves changing the rules of the game. The Banking and Securities Acts of the early 1930's that set the financial stage for almost half a century were enacted after a period of de-regulation and deflation. Should we be worrying about the kind of Banking Act (of 1983!) that may be enacted following a period of deregulation and inflation? Such are the contrary thoughts stimulated by this interesting paper.

The moral of this story is illustrated by a recent *New Yorker* cartoon which showed a Royal Privy Counselor reporting to "His Royal Highness" as follows:

> Your Majesty, according to our study the shoe was lost for want of a nail, the horse

was lost for want of a shoe, and the rider was lost for want of a horse, but the *kingdom* was lost because of overregulation.

DISCUSSION

S. M. TINIC*: Potential repercussions of increasing institutional participation in the stock market continues to be a concern frequently addressed by public agencies empowered with overseeing and regulating securities markets and commercial banks. Volumes of testimony before various committees and subcommittees of the Congress exist on different sides of the issue. Some people, concerned about institutionalization of common stock ownership, advocate restricting securities holdings of financial institutions.

As the director of the SEC's *Institutional Investor Study* almost a decade ago, Donald Farrar is one of the few individuals who are intimately familiar with the vast amount of information that is contained in that voluminous paper. In this paper, Farrar and Girton (FG) bring some of that data to bear on two questions: (1) Do the frequently expressed concerns about the growth of institutional ownership of common stock have a basis in facts? and (2) Is share ownership by financial institutions (especially bank trust departments) concentrated in particular common stocks.

After examining the data on the proportion of common stocks held by different types of financial institutions over the years, FG conclude that institutional ownership of equity securities has indeed increased. This increase, however, has been very gradual and at different rates for different institutions. FG also indicate that ownership of common stocks is relatively concentrated among large bank trust departments, large investment advisory complexes and insurance companies. Since the data pertains only to 1969, it is impossible to ascertain whether concentration of stock ownership has exhibited significant changes during the last decade.

Nevertheless, it may be appropriate to make some general observations about the gravity of increasing institutionalization of common stock ownership. Especially, for public policy purposes the following questions need to be addresed:

(1) Has the growth of large institutional investments in common stocks distorted the level and structure of stock prices and thereby detracted from the market's efficiency? (2) Do institutional investors interfere in the affairs of portfolio companies in ways which benefit them, at the expense of individuals or beneficiaries to whom they have a fudiciary responsibility? In other words, to what extent are potential conflicts of interest actually acted upon to the detriment of the investors whose funds are being managed by financial institutions? and (3) Do financial institutions garner inside information and translate it to superior investment performance, in a way which diminishes the confidence of individual investors in the marketplace?

The answer to the first question is "no." So far, there is no convincing evidence that institutions detract from the efficiency of markets in pricing securities. The

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