GEORGE EADS: I agree with Bob that a great opportunity for proposing fundamental changes in some of the environmental statutes has been missed. . . . Before Anne Gorsuch it was a close argument between the environmentalists and the economists as to whether to amend the Clean Air Act. The environmentalists would argue that we economists might gut the act, and we would insist that we'd act responsibly. But now all they have to do is ask, "How will Gorsuch administer a Clean Air Act that gives her more flexibility?" —and that's the end of the argument. Reformers can't get anybody to listen, even in the Republican-controlled Senate. So, I doubt there's any point now in trying to get the administration to change its position and propose amendments. I don't think they would be seriously considered on the Hill. ■

Financial Institutions

Kenneth Scott

THE BANKING INDUSTRY would seem a promising field for deregulation, if promise is indicated by the quantum of regulation that you can find in an industry. Commercial banks, savings and loan associations, mutual savings banks, and the like must be among the most fully, indeed exhaustively, regulated businesses in the land.

There is product regulation restricting the kinds of services banks and bank-holding companies can offer. There's a lot of regulation of geographical markets — entry, branching, whether a firm can operate across state lines. There is the extensive and traditional area of safety regulation designed to protect bank depositors, or perhaps it's the Federal Deposit Insurance Corporation (FDIC) or the Federal Savings and Loan Insurance Corporation (FSLIC) that is being protected. This includes portfolio regulation, liquidity requirements, interest rate ceilings, capital adequacy requirements, and so on. Finally, over the last decade and a half, there's been a vast growth in consumer regulation, aimed at protecting borrowers I suppose, consisting of rules on bank advertising and disclosure, truth-in-lending, and specification of the substantive terms of loan instruments in general and various mortgage instruments in particular. All of this has been added to long-standing usury regulation of lending rates.

There have also been some stirrings of regulation that can be seen as an effort at credit allocation favoring one group of borrowers over another. The Federal Reserve Board engages in this from time to time when it urges member banks, which might want to get loans from the discount window, to avoid undue increases in business credit or speculative credit or something else that's out of favor at the moment. Congress has gone further with its Community Reinvestment Act which, if it's understandable at all, has to be understood as an awkward first attempt to subsidize certain groups of borrowers: inner-city borrowers, minority borrowers, or somebody.

So with all of this regulation out there—and that's not all of it—what progress has been made? Well, a bit. The bank regulatory agencies, for example, have been engaged since 1977 in an effort to simplify some regulations and procedures, a project to which the Fed gave the literate but intimidating title of Project Augeas.

It's a minor achievement. Every time you simplify, you make the newcomer's access to that body of regulatory material perhaps a little easier, but for everybody already in the business what you mainly do with the new wording is introduce new uncertainties.

A more recent and more notable step is the Depository Institutions Deregulation and Monetary Control Act of 1980. Since this act added more regulation than it repealed, its title shows, I guess, that Congress does not apply a truth-in-labeling standard to itself.

The deregulation consisted mainly in the provisions affecting interest rate ceilings on checking accounts and on time and savings accounts, sometimes and a bit inaccurately lumped together as Regulation Q. The ceilings on time and savings accounts are supposed to be phased out over six years by the Depository Institutions Deregulation Committee, a new regulatory body composed of the heads of the banking agencies. So far this committee has been moving in less than giant steps. After eighteen months of meetings, it decided in September 1981 to raise the passbook interest rate ceilings by half a percent. At that pace, with market rates then around 16 percent and passbook rate ceilings fixed at a little over 5 percent, it would have taken quite awhile to catch up. But even that was too fast for the S&Ls: the decision was rescinded in November. At the committee's present pace, it won't finish the job in sixty years, let alone in the six required by the 1980 act.

On checking accounts, the liberalization was more decisive. The act largely repealed the ban on the payment of interest on checking accounts by authorizing nationwide NOW accounts beginning in 1981. A NOW account is a way of paying checking-account interest without admitting that that's what you're doing.

The other deregulatory action was somewhat ambiguous. The act displaces state usury ceilings on mortgages and business loans—once again we've had to learn that when usury ceilings "bite," the effect is not cheaper loans but no loans—but the act goes on to authorize the states to reinstate usury ceilings simply by voting to do so.

As to the other areas of bank regulation, there has been talk, importantly at the Treasury, but very little definitive action.

In the area of product restrictions, for example, the Reagan administration is supporting a bill that would allow banks to under-

write municipal revenue bonds and sell mutual funds. That takes us back to where we were approximately twenty years ago before the courts struck down what the comptroller of the currency tried to achieve at that time. Another administration-backed bill would give S&Ls a range of operating authority more like that of banks. There is also some indication that the Glass-Steagall Act, which prevents banks from getting very far into the securities business, might be up for reconsideration. But I have seen no move thus far to ease the restrictions on the activities of bank holding companies.

In the area of geographical market restrictions, there is also some sign of movement, of a weakening in barriers. For example, a bill being considered in the House would permit supervisory mergers across state and even industry lines. It's a pale and wan young thing, hedged about in numerous ways and threatened by a sunset clause of less than a year. Surely, at least the Federal Home Loan Bank Board (FHLBB) can, and no doubt will, do better on its own.

In the consumer area, there are several bills that might go further on usury ceilings than the 1980 act. And truth-in-lending was simplified in that act, so my professional colleagues around the country are now gainfully employed in explaining all the new and simpler rules to the industry.

This leaves vast regions of bank regulation untouched, indeed unquestioned. Why so modest an accomplishment in so promising a field? I think one reason is that in this area the costs of regulation are not well perceived by the public, whereas the benefits are presumed to be large. At any rate, the traditional forms of bank regulation are familiar and accepted. So there's little effort, either political or academic, to attack bank regulation in any comprehensive way.

The one area where my proposition about costs and benefits is not true and where there has been legislative action is, of course, that of interest rate ceilings on savings accounts. With inflation and high (nominal) market rates, the costs of those ceilings to depositors have become quite evident and quite huge. In real terms, account holders have really been paying banks and S&Ls to take the money from them; that, of course, has led to enormous market incentives to develop substitutes, and they have been duly developed. The primary example is the money fund industry, which is really a product of Reg Q.

It has long been conceded, I think, that the benefits of these regulations to depositors are nil. The old rationale for the ceilings used to be excessive competition: the banks would bid too much for deposit funds and go over the cliff like the lemmings they really are. When that rationale died, the thrifts tried to create a new one: the ceilings are really designed to subsidize housing or mortgage borrowers. That effect, unfortunately, is factually dubious, and it's not particularly attractive either to depositors or to people who are concerned with income redistribution as a goal. It represents income redistribution in reverse, from the less well-off to the more well-off.

So deregulation of interest rate ceilings is the main deregulation game in the banking town and has a lot going for it. Then why, I ask again, has progress to date been so minimal? Well, of course, because a not-so-funny thing happened on the way to deregulation—namely, the insolvency of the thrift industry. If the mortgage portfolios of S&Ls and mutual savings banks were valued at market, not cost, most of these institutions would have a negative net worth, in some cases very negative indeed.

The administration's response has been to say, "Talk to me not of market values. Let's look at book values." When one looks at accounting book values and book net worth, most of the thrifts appear solvent, although in quite a few instances rather narrowly. But current earnings, which reflect current market rates more fully on the deposit side than on the asset side, are mostly negative. So even this paper net worth is being eroded at an accelerating pace, and when it becomes zero or negative, the supervising agency almost has to act. The agency's preference always is to avoid any large immediate pay-outs from the insurance funds. So it arranges a merger with an assistance agreement that spreads the cost over a period of years—and also, by the way, keeps it out of the current budget deficit. This policy of deferred action is probably increasing the ultimate losses involved because it creates real incentive problems.

Insolvency and earnings pressures are producing some consolidation in the banking industry, which as a general proposition is needed. A total of 40,000 separate institutions—14,000 banks, 5,000 savings and loans, 20,000 credit unions —is far higher than optimal. But the kind of consolidation that's most needed is consolidation of the smaller firms, and the shakeout that's occurred so far is most notable among the larger firms.

On the other hand, the insurance corporations, the FDIC and especially the FSLIC, have very limited options. If the FSLIC recognized current market values in the thrift industry, for example, and tried to cover the resulting industry negative net worth by insurance pay-outs or assistance agreements, the outlay for the S&Ls would currently come to something like ten times the size of the agency's insurance fund.

Meanwhile, even on a book value basis, the negative earnings clock keeps ticking. The FHLBB has been trying to slow it down by playing accounting games. The industry wants operating subsidies, and its political allies prefer the operating subsidies to be off-budget; the All Savers Certificate fits both needs, which is one reason it passed so easily. Low Reg Q ceilings likewise meet those standards.

So the bank deregulation movement, if there is one, is stalled for the time being by the problems of the thrifts. The industry view is that soundness, or something else, always comes first. Deregulation comes a very distant second.

In the short run, the Reagan administration and the industry are really betting on reducing inflation rates and hence interest rates. If that happens, the earnings and the portfolio values of the thrifts will obviously both improve markedly. If it doesn't, we have the ingredients for some species of financial

crisis and a bail-out that will add considerably to budget deficits.

In the somewhat longer run, the structural vulnerability of the thrifts to this kind of squeeze has to be corrected, and the only way to do it is to broaden the composition and shorten the maturity of their assets structure while lengthening the maturity structure of liabilities —in order to get the two into a better balance. This adjustment has been under way for some time, but slowly. One of the things that tends to block it is that the industry, to the extent that it broadens its investment portfolio, loses its main claim to political favor, one that has worked well for thirty years—the theme of subsidizing housing. If we want to subsidize housing, there are, of course, much more efficient ways to do it.

Meanwhile, progress toward bank deregulation is likely to be limited and sporadic. In no regulatory area does the outcome of monetary policy, I think, seem more critical.

Finally, a few observations of a more general nature. First, banking deregulation does not yet appear to be a very high priority for the Reagan administration. Second, the deregulation that has occurred is a result of market forces that have been observable for some time. It did not come into being a year ago. And third, the present piecemeal approach tends to give the industry and Capitol Hill very much the upper hand. That leads me to ask whether there's any possibility here of applying what James Q. Wilson of Harvard calls a "point decision" or a package approach, as with the budget reconciliation bill. Piecemeal guerrilla warfare seems likely to produce very limited results for some time to come. ■

Health and Safety

W. Kip Viscusi

My review of recent risk regulation policies necessarily starts with the new oversight group within the Office of Management and Budget (OMB), because it has been the dominant force for improvement thus far. Unfortunately, OMB's efforts have not been matched by a similar commitment at the agency level.

OMB Oversight. In one of his first actions, President Reagan moved the regulatory oversight function from the Council on Wage and Price Stability (CWPS) to OMB. He also strengthened oversight in several ways—by having the reviews occur earlier in the rulemaking process before the parties were locked into their positions, by converting oversight from a nonbinding advisory activity to an institutional mechanism for screening regulations, and by establishing more stringent criteria for acceptable regulations.

These are all important and beneficial changes—except for two things. First, the OMB group needs more regulatory analysts to handle its increased responsibilities. Indeed, the distribution of its analytical capability—more paperwork personnel than policy analysts—gives one the impression that the administration is more concerned with the regulatory burden per se than with the overall merits of particular regulations.

Second, Congress should give the oversight group the same authority to file comments on the public record that it formerly extended to CWPS. Filing authority is essential for three reasons—to increase public understanding of and respect for the process, to create public debate on the issues, and to provide a check on the staff analysts, who will, I'm convinced, take their work far more seriously if they know it will be open to public scrutiny.

The benefit-cost criteria laid down in the executive order are quite good in theory and represent an important advance in centralized regulatory oversight. But the effort to put them into practice has been undercut by the Supreme Court's ruling in the cotton-dust decision that the Occupational Safety and Health Administration (OSHA) can't do benefit-cost analyses for its regulations on toxic substances and harmful physical agents. If the mandates of other risk regulation agencies are also interpreted narrowly, the present regulatory reform effort will be seriously hampered.

The full implications of the decision are not yet entirely clear. For example, is noise a harmful physical agent? And what are we to make of the fact that the cotton-dust standard upheld by the Court was *not* set at the "lowest feasible level," the concept the Court endorsed, but varied in stringency according to the stage of processing? More generally, how are regulators to proceed, given that it's impossible to define technical feasibility independent of cost considerations? Since the courts have refused to resolve these issues satisfactorily, it is clear that legislative changes are essential if the requirement that regulations pass a benefit-cost test is to become fully effective.

Until such changes occur, the question becomes: what criteria should OSHA and the other agencies use to pick regulatory targets and set standards? As for targets, in the benzene case the courts told us to focus on "significant" risks. But what is a significant risk? Isn't significance determined by the level of the risk, the number of people affected, and how severely? If we are going to calculate all of these things, why not simply calculate the overall benefits? As for standard-setting, the cotton-dust court laid down the rule of technical feasibility. But, as I've already said, this cannot be divorced from cost considerations. And, if we are going to start getting into cost considerations, why not do cost-effectiveness analysis? And if we're going to do that, and also calculate benefits, why not simply do an overall benefit-cost test?

In its first year, OMB has been applying benefit-cost criteria both to regulatory proposals and to re-