EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS

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To: Richard Breeden

Alice Williams, Secretary to
From: *WILLIAM POOLE*

Attached is the Report of Subcommittee on Goals and Missions.

Bill left for Paris Monday, 10/24/83 but wanted me to get this Report to you.

COUNCIL OF ECONOMIC ADVISERS
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MEMORANDUM FOR THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES

FROM: William Poole

Subject: Report of Subcommittee on Goals and Missions*

As the markets for financial products and services have expanded and become more competitive financial regulatory issues have become increasingly complex. The extraordinary growth in these markets can be only partly explained by greater affluence, the international character of modern capital markets, and the greater sophistication of consumers and financial firms. More important have been the volatile nature of financial markets and the increased variability of interest rates in an era of periodic bouts of inflation.

In recent years both borrowers and lenders have been subject to a higher degree of risk and the rigidities of a financial regulatory system that was created in a different era for a different set of problems. The market has introduced new financial instruments and new ways of doing business to cope with these new conditions. Supporting this growth in new product and service offerings have been major developments in

*The text through section I serves as a summary of the Report. Additional detail appears in sections II through VII. A brief description of agency missions appears in section VIII.

communications and computer technology that have not only reduced financial transaction costs but also enabled these new financial instruments to compete efficiently in the market.

The rapid pace of change in U.S. financial markets has raised fears of two kinds. On the one hand, a cumbersome regulatory system raises costs and unnecessarily slows the rate of innovation. On the other hand, some essential regulatory functions may now be performed poorly or, even worse, may promote perverse results in the financial market-place. In this situation it is appropriate to return to basic principles -- to focus on the essential goals of financial regulation in order to guide reform of the existing regulatory system.

I. Overview and Summary of Goals

The United States is frequently described as having a "mixed" economy because economic activity is guided by a combination of market forces and governmental interventions. With our basic allegiance to the competitive market, our regulatory agenda and our attitude has been to leave the market alone unless a case can be made to justify government intervention; regulation is a reaction to perceived problems with the way unconstrained markets work.

Over the years the scope of government intervention has increased enormously as many have believed that changing times have required a larger role for government. Intervention has also grown because so little attention has been devoted to abolishing regulations that have outlived their usefulness or that experience has shown to have been unwise from the start. It always seems much easier to add to government's presence than to subtract from it.

The Market Standard. Because there is a broad consensus in the United States on the merits of competitive free markets, the only satisfactory frame of reference for evaluating regulatory issues is that of the behavior of unconstrained markets. The purpose of regulation is to change the way markets work; the success of regulation is to be judged by comparing the performance of the market with and without regulation.

Emphasis on competitive market behavior is also important for understanding the viability of regulation. The substantive merits of a proposed regulation are irrelevant if it can be expected that market participants will be successful in their attempts to avoid the consequences of the regulation. Analysis

of regulation and discussion of its goals should always consider market avoidance strategies. That is, the probable effects of the market on regulation must be analyzed along with the probable effects of regulation on the market.

Stability of the Financial System. Without question, of all the goals of financial regulation the goal of stability of the financial system is paramount. Panics in financial markets and widespread bankruptcies of financial firms are associated with serious recessions or even depressions. Financial disorder can also lead to inflation, destroying the value of the currency. Maintenance of the value of the currency can be considered basic in any discussion of the stability of the financial system. The costs of financial instability and associated recessions or inflation are so large that all other regulatory goals must be considered secondary. Control of money creation, assurance of the liquidity of the financial system, and maintenance of sound capital structures are all key elements in achieving financial stability.

It should be remembered, however, that the primacy of the goal of stability of the financial system is within the context of an economy largely organized on market principles. It would

be inappropriate to advocate centralized federal control over the entire economy for the purpose of achieving financial market stability. Because of the close connections between financial and other markets -- connections that make financial disorder so costly -- regulation of financial markets must be consistent with the role of government more generally in our economy. Regulations should be designed to achieve stability of the system, while individual firms are afforded the maximum possible freedom to compete and innovate. The purpose of regulation should not be to protect poorly managed individual firms from failure but rather to prevent such failures from shaking the stability of the financial system as a whole.

Consumer Protection. The goal of financial stability is, of course, central to the goal of consumer protection. In addition, the regulation of financial services recognizes contract enforcement and fraud prevention as important and traditional functions of government. Disclosure requirements provide the information that consumers need to make sound financial decisions, and thereby reinforce the market mechanism. Deposit insurance protects consumers and also helps to stabilize the financial system.

Two questions are relevant in assessing the value of particular consumer protection regulations. First, do the regulations provide something the market does not, or cannot, provide? For example, the market provides an enormous amount of information in the form of investment advisory services; thus, disclosure requirements, beyond some point, may add little or nothing to the information available to investors. Second, are the benefits of the regulations worth all the cost, including indirect costs?

<u>Efficient Regulation of Financial Services</u>. Financial instability in the 1930s was widely attributed to the "natural" operation of competitive markets, and this view supported a very substantial extension of regulatory controls over financial markets. More recently, however, we have seen a renewed respect for the efficiency of competitive markets and a more sober appraisal of the costs of regulation. Regulation tends to spread in unproductive directions and regulators are sometimes "captured" by regulated industries. For these reasons, the promotion of efficiency by furthering competition is an important regulatory goal. Antitrust policy, prevention of excessive concentration, and freedom for financial firms to innovate are all important. In some respects, however, there

is a tension between efficiency and the stability of the system This tension must be faced with each proposed change in regulatory policy.

The direct costs of regulation to the government and to consumers should be minimized. A major issue in this regard is the organizaton of the regulatory agencies. Conflicting jurisdictions and overlapping responsibilities should be eliminated wherever possible.

The major problem in addressing the issue of the organization of regulatory functions is that the broad principles of business organization may not be entirely applicable to government organization. The American concept of checks and balances within government may require trading off the risks of abuse of concentrated power against the extra delays and costs of multiple government regulators.

Market Allocation of Credit. Any move toward increased market efficiency threatens some group's traditional share of the total market for credit, perhaps jeopardizing their real incomes and jobs. Efforts of regulators to direct credit to small business, to housing, to state and local government,

to agriculture, or to other sectors deemed to be deserving of special assistance are not likely to be successful because money is fungible. Credit specifically allocated to a particular sector displaces other sources of credit as rates of return fall.

Credit allocation is not only ineffective but also weakens financial firms operating under complicated and ever changing government directives. Efforts to direct credit toward particular sectors, if deemed desirable, should rely on tax incentives and subsidies that sustain rates of return on the investment. Additional important advantages of employing tax preferences and direct subsidies is that their costs are more readily calculated and they are more likely to be monitored by budget and legislative review than are credit allocations through regulations.

II. The Limits of Competitive Markets As a Frame of Reference

The free market standard underlying this Report provides the basis for judging the effectiveness of regulation and the conflicts among regulatory goals. Regulation must tangibly improve the behavior of unconstrained financial markets. Regulation that interferes with market processes without

producing clear benefits or that merely duplicates the results of market processes should be eliminated.

A corollary to the competitive standard is the need to maintain market entry as open as possible. Cost studies generally suggest that in banking and in other financial services markets, scale economies are achieved at such a modest firm size that it is possible for relatively small new firms to be successful in entering the market. Because there are no significant technological barriers to entry and because a very large number of financial firms already exist, the key elements of a competitive market are in place.

In general, the economic theory justifying regulation relies on the concept of "market failure", a condition where market outcomes depart from ideal competitive market results. In this regard it is useful to divide regulatory goals into two basic groups. One group involves goals intended to correct market imperfections. The concern here is the performance of unrestrained financial markets--how closely they approximate the perfect market of economy theory--and whether regulatory interventions in fact improve the functioning of these markets by correcting market failures.

The other group of regulatory goals contains those that seek to modify the behavior of markets away from that of the perfect market because, in certain respects, the standard of the perfect market of economy theory may be rejected. For financial markets, the issues raised in this regard are usually those of market stability and risk rather than efficiency. We may choose to incur the cost of regulation to avoid even a low probability of a disastrous outcome that might occur in the absence of regulation.

Historically, most financial regulation arose following crises or severe problems in financial markets. If regulation was triggered by particular historical episodes--for example, the financial problems during the Great Depression--it is important to examine whether the conditions that gave rise to regulatory intervention still exist.

III. Stability of the Financial System

In the United States, bank failures and other financial problems during periods of depressed economic activity have led to extensive regulatory control over financial institutions. Without prejudging whether past extensions of regulation reflected sound analyses of stability problems in financial

markets, it is clear that the overriding goal of financial regulation must be to stabilize the financial system and the economy as a whole. It is equally clear, however, that no degree of regulation can prevent all failures among regulated institutions, even assuming that it were decided to incur the enormous subsidies (explicit or implicit) that would be necessary in any attempt to do so. Consequently, some individual firms will fail; a principal public policy question is what level of subsidy we are willing to pay to maintain a particular limit on the failure rate.

Sharp changes in economic conditions place generalized pressures on financial institutions. Rising inflation and interest rates in the late 1970s produced serious problems for the thrift industry. Recent recessions accompanied by rising bankruptcies and loan defaults also weakened the balance sheets of many financial institutions.

Because both inflation and recession place strains on financial institutions, financial regulation should support monetary and fiscal policies directed toward achieving overall economic stability. But in the 1970s market avoidance of financial regulations--especially the interest rate ceilings

embodied in Regulation Q--complicated the task of monetary policy. Regulatory avoidance led to disruptive flows of funds out of time and savings deposits when interest rates rose, and to the invention of new financial instruments, such as NOW accounts and money market mutual funds, that produced a degree of confusion in the measurement of the monetary and credit aggregates.

One approach to avoiding these policy difficulties would be to tighten regulations on deposits and near-monies by strict regulatory control over deposit creation. The problem with this approach is that it is in conflict with the goal of fostering innovative competitive financial services markets. Of particular importance in this regard is that it is probably not possible to maintain the long-standing policy of promoting highly competitive and open capital markets while at the same time adopting much tighter regulations over depository institutions and close money substitutes in the money markets.

Frequently overlooked in discussions of regulatory reform are the indirect effects of regulation on monetary policy. While information on financial flows, interest rates, and other credit terms is frequently a by-product of regulatory

activities, timely and comprehensive data to support monetary policy are essential. Also, as noted above, regulatory avoidance in the depository end of the market will complicate monetary policy insofar as the definition and measurement of monetary and credit aggregates become muddied.

To maintain overall stability the essential function of regulation is to isolate financial disturbances and prevent them from spreading to other financial intermediaries. Bank examinations, deposit insurance, liquidity support, and mergers all serve to minimize the secondary effects of a liquidity crisis in an individual bank. Limited deposit insurance, while not preventing large uninsured depositors from transferring funds out of troubled institutions, does eliminate the incentive for bank runs by small depositors.

The solution proposed by some of extending full deposit insurance to all deposits regardless of size raises other problems, for it means that the government would be transferrig risks from more risky to less risky institutions, or possibly to taxpayers in general. The incentive to sound bank management afforded by potential outflows of funds should not be completely eliminated.

In addition, security market risks should not be shifted to deposit insurance funds when these risks should be borne by large investors. For example, nonfinancial firms that have the alternative of issuing commercial paper ought not to be given an artificial incentive to take out bank loans merely because the loans are supported by fully insured, and therefore low cost, deposits. Market assessment of risks ought to continue to determine interest rate differentials in the commercial paper and commercial loan markets. Otherwise, regulators will have to make judgments on risks and either charge differential insurance premiums or control bank portfolios more directly.

There is, in short, an inherent tension between pursuing the goal of financial stability through deposit insurance and the goal of encouraging efficient competitive markets for financial services. The proper aim of deposit insurance should be the protection of small depositors. Such depositors generally lack the expertise to evaluate bank safety and may on occasion join irrational runs against basically sound banks. Ill-informed movements of funds do not provide an incentive for good bank management; thus, deposit insurance for small accounts increases stability without decreasing efficiency. But the larger the accounts subject to full deposit insurance

the greater is the trade-off between stability and efficiency. Beyond some point, deposit insurance may actually increase overall riskiness, and therefore the instability of the financial system, by relaxing credit standards and encouraging unsound loans.

The traditional central bank function of serving as a lender of last resort provides another example of the tension that can develop between actions taken to promote stability and and those to promote competition. Central bank loans to financial institutions with strained liquidity positions are designed to keep sound firms afloat. But it is frequently unclear, in any particular case, whether a firm suffering liquidity strains is a soundly managed one with solid loans and investments. Lending too freely to strained firms can degenerate into a bail-out policy that not only is expensive to taxpayers but also may create an environment that encourages unsound practices on the part of other firms.

In dealing with the tension between financial stability and efficiency it is important to recognize that the goal of stability is not inconsistent with the failure of individual financial institutions, with accompanying losses to

depositors, stockholders, and managers. The greater the risk of loss from bad decisions the greater the incentive for good management of financial institutions, which leads to better allocation of capital, the provision of financial services at lower cost, and reduced risk of insolvency. However, maintaining the stability of the financial system requires that generalized financial panics be avoided so that the problems of one financial firm do not spread to the whole system.

IV. Stability of The Regulatory Environment

Many, though not all, regulations impose costs on regulated firms and their customers. Under such circumstances, there is a market incentive to avoid the costs by avoiding the regulations. In some cases, regulation may do more to change the forms than the facts of market behavior. Regulatory avoidance--an inevitable and predictable result of costly regulation--erodes the effectiveness of regulation over time.

One governmental response to the trend toward increased avoidance may be the spread of regulation to additional markets and firms. However, the spread of regulation increases costs and frequently has undesirable side effects. Moreover, regulatory avoidance behavior is simply displaced to new

areas. All regulation, and especially financial regulation, risks a never-ending process of regulatory response followed by market avoidance as organizational innovations are quickly made.

Where the goals of regulation are deemed important there is only one possible way to maintain a stable regulatory environment in the face of market avoidance tactics. The costs of compliance must be minimized and offset as necessary to prevent unregulated firms from using cost advantages to displace the regulated firms. For example, payment of interest on required reserves on deposits or the provision of tax advantages for regulated firms can offset the necessary costs of regulation.

The principle of "competitive equity"--the so-called "level playing field"--is essential to maintaining a stable regulatory environment in which all firms are treated in a fair and equitable manner. Different types of financial institutions compete, to a greater or lesser extent, with each other in various financial markets. For all to prosper it is necessary to maintain at least a rough parity in competitive conditions. Parity, however, does not require that all

financial institutions have the same powers; all that is required is that those firms whose powers are restricted by regulation be compensated in some fashion so that they are not at a competitive disadvantage.

V. <u>Consumer Protection</u>

Most aspects of regulation in the financial markets involve consumer protection issues of one kind or another. Those issues, such as stability, that are peculiar to financial markets have been discussed above. Other issues -- those that arise in a wide range of markets -- are examined in this section in the financial market context.

Traditional functions of government are to enforce contracts, to attack fraudulent representations, and to discourage "over-reaching"--practices on the borderline of legality. Many of the activities of Federal regulatory agencies are concerned with these police functions.

Some financial regulation is rather similar to the maintenance of weights and measures standards. The definitions of a "deposit" and of a "broker" are controlled by regulation and licensing. The enforcement of standards makes markets more

predictable and efficient, and reduces the opportunity for consumers to be misled by false claims. However, such standards should not be so rigid as to exclude innovative products and services from the market. Licensing of individuals and chartering of institutions may be necessary to insure minimum levels of competence, integrity, or capitalization. However, such requlatory purposes should not become an excuse for merely limiting the number of competitors in the market, artifically driving up the costs of entry, or increasing the costs of competitors in related markets.

Disclosure requirements have been an important part of consumer protection policy in the United States particularly in financial markets. Following the general principle of attempting to improve market performance, disclosure of relevant facts and terms in the marketing of securities and credit should be required by regulation. This data base informs the judgment of both investors and borrowers and is essential to the proper functioning of a deregulated, market-based financial system.

There is the danger, however, that disclosure requirements may produce masses of data that cannot be readily assimilated.

To a greater degree than in most consumer markets, objective information about particular financial products and services can be obtained from third-party firms. Private firms producing general circulation magazines, market newsletters, investment advisory services, and company ratings have long played an important role in U.S. financial markets.

With the rapid strides in personal communication and computer technologies, investment information has become even more extensive and timely. Consequently, the additional costs of disclosure requirements must be weighed against the benefits actually realized in the form of more efficient markets and greater consumer protection.

It is important to note that in an unregulated competitive market the absence of a particular kind of information may reflect the lack of demand for the information rather than the lack of supply. Thus, regulations requiring release of specific data may in some cases add to costs without producing material information.

In examining consumer protection issues, deposit insurance deserves special attention. An important function of deposit

insurance is to provide for the absolute safety, in nominal value, of the funds of relatively small depositors. While deposit insurance provides for the existence of safe assets, it is not the function of government to substitute its judgment for that of individuals in assessing investment opportunities, risks, and returns. It ought not to be a goal of regulation to protect small savers who voluntarily hold wealth in a variety of risky financial assets rather than in insured deposits.

In sum, the goal of consumer protection is an important one for the financial regulatory agencies. The general approach followed--to prevent fraud and misleading practices, and to provide consumers with an information base to make wise financial decisions--is sound. Nevertheless, specific regulations must be judged against the background of market mechanisms that also provide consumer protection. Excessive regulation, though intended to promote consumer protection, may have unwanted effects: increased consumer costs, delays in transactions, and a reduced pace of innovation. The public is only truly "protected" when the benefits of additional regulations exceed their costs.

VI. Efficient Regulation of Financial Services

The benefits of regulation--the fostering of competitive conditions, the maintenance of financial and economic stability, and soundness--must be set against the cost of regulation. These costs include costs to taxpayers, compliance costs to firms, and costs to users of financial services who receive lower returns or pay higher prices than would otherwise be the case.

The costs of regulation can be reduced by decreasing the amount of regulation and by pursuing regulatory objectives through more efficient techniques. Opportunities exist in most areas to pursue regulatory objectives through greater reliance on market mechanisms. The substitution of prices and fees for regulatory prescriptions provides unambiguous and immediate financial incentives to both the regulated firms and the regulators.

The issue of the administrative costs of financial regulation has arisen repeatedly over the years directing attention to the Federal regulatory agencies which appear to be organized in apparently conflicting and overlapping structure. Many institutions find themselves burdened with multiple regulations that seem excessively costly. Reorganization of

the Federal regulatory agencies can achieve important efficiencies by reducing duplicative regulatory burdens on the private sector.

Although the problems raised by conflicting and overlapping regulatory jurisdictions are no doubt real, centralization of the Federal regulatory structure could also conflict with the goal of encouraging a competitive organization of the financial industry. Multiple regulatory agencies have fostered a diverse and innovative financial system. Moreover, the present regulatory structure is consistent with long-standing policies of providing for a system of checks and balances within government. A "logical" organization of regulation into a unitary structure might eliminate some duplication and conflicting jurisdictions, but at the same time it could reduce the diversity of the financial system and its competitive, innovative nature. Therefore, any reorganization plan must carefully balance both the obvious administrative benefits of centralizations and the less obvious costs and dangers of excessive regulatory power that might result from concentration of regulatory authority.

Under the current system financial institutions can, to some extent, "shop" for their regulators by changing their charters. This shopping is one aspect of the system of checks and balances within government. But, while it is in the public interest to constrain government power, it is not always in the public interest to permit such shopping especially where there may be a "competition in leverage" that would create competitive advantages for financially weak firms.

VII. Market Allocation of Credit

Financial regulation currently attempts to assure open access to credit on a nondiscriminatory basis. This goal is generally accepted, although there are considerable differences of opinion as to what specific regulatory actions in fact promote open, nondiscriminatory access to credit.

Some have felt that special regulatory attention should be given to lowering institutional barriers to credit for small business, homeowners, state and local governments, and perhaps others. Experience suggests, however, that attempts to use regulation to provide special access to credit for particular sectors is inefficient and usually unsuccessful in the long run.

Attempts to maintain special access to credit through regulation almost always involve the creation of regulatory costs for particular institutions. These costs depress rates of return. Lower rates of return cannot be maintained indefinitely through regulatory constraints; funds simply move elsewhere. Thus, efforts to achieve special access, or lower credit costs, should not be pursued indirectly through regulation, but rather directly through tax and expenditure provisions that raise returns to market levels and channel funds to the particular institutions and sectors that have been targeted.

VIII. Summary of Agency Missions

The agency missions identified in this section are directed toward promoting the goals of stability and soundness of the financial system. Regulation of institutions begins with licensing, registration, and chartering provisions and includes direct supervision, examinations, and standardized rules for internal reporting and public disclosure. The goal of protection of the investing public is accomplished through oversight of financial markets and financial institutions as well as deposit insurance programs.

Federal regulatory agencies follow a conservative approach to the goal of safe and orderly expansion of financial services available to the public. Competition among financial institutions is assured by a decentralized strategy whereby agencies focus on the established financial institutions that they individually regulate. This approach encourages competition and furthers the evolution of new institutional arrangements and financial instruments.

The Commodity Futures Trading Commission regulates futures trading in a broad range of products and instruments under a uniform national regulatory system while ensuring that competitive market activities are conducted in a fair and orderly manner, free from fraud and manipulation.

The CFTC has followed a functional approach to the regulation of all futures trading under which the same basic economic and legal standards are applied to futures contracts for all types of products (e.g. farm commodities, precious metals, energy resources, and financial instruments). With this approach a single contract market can, for example, trade futures on grain and a stock index under the same regulatory

structure. The economic purpose of futures as commercial hedging and price basing instruments remains the centerpiece of CFTC regulation.

Fair and orderly market activities are assured by statutory and regulatory provisions for: (1) the licensing of contract markets to trade only those futures contracts providing the described economic services; (2) the registration of industry professionals who deal with the public; (3) reporting and market surveillance programs designed to prevent excessive speculation and manipulated price movements; (4) industry self-regulation by the contract markets and designated futures associations; (5) proscriptions against fraud and other market abuses; and (6) a wide array of enforcement tools.

The resulting regulatory structure reflects a balance between industry self-regulation by the organized futures exchanges and the National Futures Association, and governmental oversight by the CFTC, to ensure adequate customer protection as well as market integrity.

The Comptroller of the Currency promotes and assures the safety, stability, competitiveness, efficiency, and integrity of the national banking component of the financial system.

The regulatory philosophy of the OCC is that a relatively free competitive marketplace, both domestic and international, offers the best assurance that the financial system will make available to the public the widest possible array of financial services at the lowest cost. A corollary is that such a marketplace is the most efficient allocator of financial resources.

The principal statutory role of the OCC is the supervision of the national banking system which is a component of the financial services industry and the capital market system. While supervision includes examination of and selective intervention at banks to accomplish OCC goals, it also encompasses a wide variety of other activities whose purpose is to ensure that national banks remain a vital part of the financial system.

The OCC mission involves a balancing of often conflicting concerns and reflects the conviction that, given a reasonably stable marketplace, the welfare of the users of financial

services is the primary concern. The prime interest is the development of a superior financial services system offering lower costs with acceptable market risks and the provision of financial services without prejudice and on a fair basis to all customers. OCC also strives to improve the competitive capability of the national banking system.

The Federal Deposit Insurance Corporation fosters strength and stability in the financial system through deposit insurance and an associated program of supervision and enforcement designed to maintain an acceptably low level of bank failures. Ancillary to this mission is the function of acting as receiver of failed national and state chartered banks.

The FDIC administers other essential statutory provisions relating to bank financial reporting, creation of deposit insurance banks, payment of insured deposits, assistance to insured banks, extraordinary acquisitions, and the authority to borrow from the Treasury.

The FDIC also has certain other responsibilities that are extraneous to its fundamental mission of providing deposit insurance and administering the deposit insuranc system.

The Federal Home Loan Bank Board regulates all federally-chartered savings and loan associations and savings banks, and all state chartered thrifts whose deposits are insured by the Federal Savings and Loan Insurance Corporation. To accomplish its mission the Bank Board has supervisory responsibility over The Federal Home Loan Bank System, The Federal Savings and Loan Insurance Corporation, and The Federal Home Loan Mortgage Corporation.

The Federal Home Loan Bank System provides a flexible credit reserve for member institutions through granting loans to members in the form of advances.

The Federal Savings and Loan Insurance Corporation (FSLIC) insures the safety of depository accounts in thrift and home-financing institutions. To accomplish this end, FSLIC can make loans, grants, or special contributions and can purchase financial assets. Often, these actions are taken to put the association on a sound fiscal basis to facilitate mergers.

The Federal Home Loan Mortgage Corporation operates a secondary market in conventional home mortgages by purchasing, packaging and selling a wide variety of conventional mortgage instruments.

The Federal Reserve System promotes a stable and smoothly functioning financial system, one that is capable of meeting the financial requirements of the Nation under a variety of circumstances. As the Nation's central bank the FRS controls the creation of money and serves as the fiscal agent for the U.S. Treasury.

This mission involves a variety of actions. Most importantly, the FRS controls the creation of money, which affects interest rates and aggregate volume of credit, in order to attain the Nation's goals of price stability and satisfactory economic performance. The FRS exercises supervisory powers and provides loans through its discount window to prevent an individual financial institution's difficulties from affecting the soundness of the entire financial system and therefore of the economy. The FRS performs both oversight and operational roles in the payments mechanism which links the various parts of the economy together. Finally, the FRS has responsibility for enforcing laws intended to promote fairness in the dealings of depository institutions and other financial institutions with the public.

The National Credit Union Administration supervises the safe and sound operation of federally chartered credit unions and provides "last resort" insurance of credit union shares and liquidity/stabilization lending.

Chartering, supervision, examination, insuring, education, and lending activities are combined in this organization which has a multifunctional examiner force and is funded directly by the credit unions. The development of these "specialized" activities reflects the unique character and financial structure of credit unions and the fact that they are nonprofit cooperative financial institutions controlled by their share holding members.

The Securities and Exchange Commission protects investors in the securities markets against fraud and unethical practices. The SEC promotes investor confidence in the securities markets in order to foster efficient capital allocation and to facilitate capital formation.

The Commission pursues these goals in several ways. First, the Commission administers a system of mandatory disclosure by issuers that sell their securities to the

public. Second, the Commission establishes a regulatory framework for creating and maintaining fair, orderly, and efficient securities markets. In this pursuit, the Commission relies heavily on self-regulation by the securities industry on the assumption that the industry itself has the resources, motivation, and expertise to establish and maintain high standards of professional conduct. Third, the Commission provides for the safety and soundness of securities institutions and the system as a whole with its broker-dealer net capital and customer reserve requirements. It also plays a role in providing limited individual protection against broker-dealer insolvency through industry-sponsored insurance for securities customers. Finally, the Commission closely regulates the structure and activities of investment companies.