Policy Analysis

Cato Institute Policy Analysis No. 85: Nonbank Banks Are Not the Problem

April 28, 1987

Catherine England

Catherine England is a senior policy analyst at the Cato Institute and directs its Financial Deregulation Project.

Executive Summary

Much has been said and written about nonbank banks. To some, limited-service banks are a shelter through which the parent organizations can conduct business critical to their continued profitability and even survival. To others, they are mongrel institutions born of efforts to evade legitimate strictures imposed by congressional intent as well as a threat to the interests of the traditional banks and their customers.

Exactly what are the organizations that have elicited such a fierce debate? Are they in fact free of regulation and oversight? Could they cause a 1930s-style systemic collapse? Or are they a valid means of serving the interests of consumers?

The debate over nonbank banks has been marked by considerable misunderstanding--not surprising when one considers the name. As Congress sets out to deal with the "problem" of nonbank banks, however, it is particularly important for policy--makers as well as the general public to set aside the myths and misconceptions and view the nonbank bank issue as objectively as possible. Toward that end, this study defines nonbank banks and describes the regulation to which they are subject. The objections of those who oppose nonbank banks are outlined, as are the arguments of those who own such banks. The relevance of nonbank banks to the broader debates over interstate banking and the powers exercised by depository institutions is also detailed.

As complicated as the nonbank bank issue is, the existence of such banks is not the real problem faced by Congress, the federal regulators, and the banking industry. Nonbank banks are a symptom of a much more serious malaise. The fundamental question is what long-term economic role banks and other financial institutions should play in the face of an increasingly competitive environment. Attempting to address the nonbank bank issue in isolation will only put off the day when the profound changes occurring in the domestic and international financial markets have to be reflected in the regulatory structure.

What Are Nonbank Banks?

To understand the genesis of nonbank banks, it is necessary to examine the Bank Holding Company Act of 1956, a key piece of legislation enforcing the banking regulation of the 1930s. The act, as amended, has two broad purposes: 1) to enforce the separations between banking and commerce and between banking and most other financial services, and 2) to prevent banks from expanding across state lines through the device of wholly owned subsidiary banks.

The Bank Holding Company Act defines a bank as an organization that "accepts demand deposits and makes commercial loans." It then subjects corporations that own banks--bank holding companies--to regulation by the Federal Reserve Board. Among the things that the Federal Reserve Board is to determine is what business activities a bank

holding company may pursue, either through the parent organization or through its nonbank subsidiaries. Such activities must be "closely related to banking and a proper incident thereto." In addition, the Douglas Amendment to the Bank Holding Company Act prohibits banks from establishing de facto interstate banking through the purchase of wholly owned subsidiary banks in other states unless such acquisitions are approved by the relevant state legislatures.

Both limited-service banks and the use of the term "nonbank banks" to describe them arose because of the word "and" in the Bank Holding Company Act's definition of a bank. If a financial institution either accepts demand deposits (that is, checking accounts) or makes commercial loans but does not do both, it is not a bank for the purposes of the Bank Holding Company Act.[1]

Because limited-service institutions fail to satisfy the legal definition of a bank, neither their parent corporations nor other subsidiaries are subject to the strictures imposed by the act. They may engage in any activities they wish, including activities that are closed to traditional banks and to bank holding companies--manufacturing, retailing, corporate securities underwriting, and insurance brokerage, to name a few. Not only can anyone acquire a nonbank bank, but one can do so anywhere, thereby breaching the law's geographic restrictions as well.

Most nonbank banks accept deposits but make no commercial loans; they lend only to individuals.[2] Hence, their owners tend to prefer the term "limited-service banks" or "consumer banks." Companies in a wide range of industries have obtained limited-service banks--retailers, such as Sears, Roebuck and J. C. Penney; other financial institutions, such as Fidelity Federal Savings and Loan Association in California, Shearson/ American Express, and Prudential Insurance; and conglomerates, such as Gulf & Western and Control Data Corporation--and they have done so for a variety of reasons. Gulf & Western, one of the first companies to acquire a limited-service bank, uses its nonbank bank to support its credit card and consumer lending activities. Merrill Lynch obtained its nonbank bank so that it could process its cash management account customers' check and credit card transactions in-house. Other firms have acquired nonbank banks in order to offer customers access to their funds through nationwide automatic teller machine networks.

Most nonbank banks are federally insured and consequently are regulated by the Federal Deposit Insurance Corporation and subject to capital and reserve minimums, examinations, and other requirements much like those imposed on full-service banks.[3] It is not the nonbank banks themselves that are unregulated; it is their parent organizations that enjoy more freedom than the owners of traditional banks.

The Case against Nonbank Banks

Those who oppose nonbank banks cite any of several reasons for doing so. They may object to the absence of geographic restrictions on who may own nonbank banks; they may object to the

powers that can be exercised by the parent companies of nonbank banks; or they may argue that whatever the merits of nonbank banks, it is unseemly to allow their owners to exploit a technicality and thereby violate the spirit of the banking laws.[4]

Support for Geographic Restrictions

This country has the most decentralized banking system in the world. Maintaining that distinction has long required both state and federal legislation that restrains branch banking and shuts down interstate banking innovations as soon as they appear. To the extent that nonbank banks are allowed to exist and expand, they undermine our highly decentralized banking system and hasten its demise. Many large regional and money-center banks own nonbank banks precisely because doing so allows them to attract and accept savings deposits and generate consumer loans outside their home markets--that is, to operate what are in effect interstate branches.

Many of those who oppose nonbank banks maintain that the deposits they gather are not likely to remain in the same community. Such opponents paint a scenario in which funds are gathered from the nation's small towns and used to support lending activities in its major cities, particularly those on the East Coast. The large money-center and regional banks that expand by purchasing nonbank banks are expected to offer higher interest rates on deposits, a wider range of services, and sometimes even lower interest rates on loans--enticements that will threaten the ability of locally

based institutions to compete and survive. Once the local banks are gone, it is argued, service to consumers in less-populated areas will suffer because the owners of nonbank banks will turn their attention back to consumers in big cities.

Those objections are not unfamiliar to anyone who has studied the struggle against interstate banking in this country. They echo 200-year-old populist concerns about the concentration of power and the evils perpetrated by money-center bankers. Not surprisingly, objections to the absence of geographic constraints for nonbank banks are often raised by the owners and managers of depositories in areas where new bank entry has been limited, and hence local market power protected, by restrictive branching laws. Certainly the presence of nonbank banks tends to weaken traditional depositories' market power and will further legitimize the spread of cross-state banking.

Support for Powers Restrictions

Those who object to nonbank banks on the basis of the powers that can be exercised by their parent companies and other subsidiaries fall into two camps. The first supports the traditional separations between commerce and banking and between banking and other financial services, such as insurance underwriting and brokerage, real estate development, and securities underwriting. The second contends that cordoning off banking into a narrowly defined set of activities is unnecessary and potentially destabilizing. Members of the second camp cite competitive inequities--owners of nonbank banks may provide their customers with a variety of services in a range of locations that traditional banks and bank holding companies cannot match.

Members of the first camp often assert that to protect the safety and soundness of the nation's banking system, the activities of banks and their parent corporations must be subject to federal scrutiny. Paul Volcker, chairman of the Federal Reserve Board, has been one of the leading proponents of that position. It is his stated opinion that continuing to allow nonbank banks to operate would be indicative of a failure "to respect the uniqueness of banking." In that vein, he proceeds:

The ensuing questions of conflict of interest, undue concentration of resources, unfair competition, and the transmission of unregulated risks to the financial system would hardly be consistent with long-standing public policy and the operation of the federal safety net.[5]

Such concerns frequently arise from the belief that it was excessive competition among banks and their participation in the securities markets in the 1920s and the early 1930s that made them particularly vulnerable during the Great Depression.[6]

An often-heard concern is that a nonbank bank might be forced to lend to its parent or to another subsidiary at preferential interest rates and without proper credit quality controls. Should such loans sour, they could endanger the bank. Even in the case of subsidiary banks that do not make commercial loans, it is feared that the public will nonetheless become concerned about the stability of a depository associated through a holding company with an ailing firm. Such concerns might lead to a bank run, it is argued, and because runs are widely believed to be contagious, it is feared that the resulting unease could spread throughout the system.[7]

Another oft-heard objection to the lack of regulation of nonbank banks' parent companies is that tie-in sales will result. Those who oppose retailing, insurance, and securities firms' ability to purchase banks frequently speculate that customers of those highly diversified firms will be coerced into buying goods and services they do not want at above-normal prices. That is, they envision a consumer loan being approved only if the customer agrees to buy his health insurance or his new carpeting from the insurance or retailing subsidiary of the holding company.

There are also those who argue that it is unfair to allow banks, whose funds are guaranteed through federal deposit insurance, to become major participants in the securities and insurance markets. They contend that nonbank banks' government guarantees, implicit as well as explicit, give them an advantage over traditional securities and insurance firms in raising operating capital. In a similar vein, opponents of nonbank banks contend that allowing retailing, insurance, and securities firms to own federally insured banks gives them access to funds (raised as deposits) for which they will pay lower interest rates (because the deposits are perceived to embody less risk) than are paid for unguaranteed funds raised through the capital markets. Thus, such firms that own banks are believed to have an unfair

advantage in attracting customers because they can afford to charge lower rates on extensions of credit.

Finally, even observers who generally advocate less regulation express anxiety over the prospect that if a nonfinancial parent begins to slide toward bankruptcy, regulators' fears that its failure will undermine the stability of the banking subsidiary will lead them to bail out the parent, its creditors, and other subsidiaries. Given that the federal deposit insurers--particularly the Federal Savings and Loan Insurance Corporation--are having difficulty handling depository failures alone, it is argued, the contingent liabilities that might result from expanded ownership of banks would create serious problems.

Of course, many argue that potential problems can be eliminated through laws and regulations limiting or prohibiting tie-in sales, intracorporate and affiliate lending, and federally sponsored financial aid to the parent firm and other subsidiaries of a holding company that includes a bank. Those who take this position, among them the owners of many large and mid-sized banks, maintain that the problem with nonbank banks lies not in the fact that securities firms, insurance companies, retailers, and manufacturers can own banks and engage in a wide range of other activities but in the fact that traditional bank holding companies are prohibited from responding to the competitive challenges that result.

The world in which banks compete has changed dramatically over the past 10 to 15 years. Telecommunications technology has advanced to the point where the international capital markets are rapidly becoming one. The highly volatile period of the 1970s and the early 1980s caused institutions of many stripes to develop and market innovative financial products designed to allow even middle-income individuals to achieve a greater return on their savings and investments. The competitive pressure on banks is heightened when nonbank financial firms can offer close substitutes for banking services (such as checkable accounts) and banks are prevented from responding with innovations of their own.

Support for a Decision by Congress

Finally, there are those whose opposition to nonbank banks is based solely on the contention that they pass through a legislative loophole. Such opponents maintain that whatever the merits or drawbacks of nonbank banks in regard to geographic expansion and powers liberalization, long-standing financial policies should be changed only after an open debate. It is only through such a public debate, it is argued, that all the players will have a fair opportunity to voice their concerns and that adequate safeguards can be devised.

In fact, many congressional advocates of a "clean loophole closer" maintain that they want to eliminate the nonbank bank issue in order to clear the table for debates and legislative proposals on a more substantial restructuring of the regulatory system. But proponents of a less regulated financial services industry appear to be wary of such a deal--and for good reason.

The financial services industry has a large number of special interests. Even banks rarely speak with one voice, let alone securities dealers, real estate brokers, mortgage lenders, and insurance companies. The cacophony of competing opinions, desires, and needs will make it very difficult for Congress to settle on a legislative package that can achieve the support necessary for passage. Significant congressional action requires an engine--something that drives change--and one current engine is the competitive inequity illuminated by nonbank banks. If Congress simply closes the limited-service bank loophole, the chances of obtaining significant congressional action on many of the other pending issues will be slim. Hence, there is a need to consider nonbank banks in the light of the broader changes occurring in the financial markets.

The Changing Financial Services Markets

Why have nonbank banks become such a widely debated policy topic over the past few years? The loophole has existed for 30 years, but the first nonbank bank was not established until 1980. Since then more than 200 nonbank banks have been formed, and more than 200 applications are pending. Are nonbank banks simply the latest fad in the financial services industry, or are substantial changes in the industry making them increasingly attractive?

One of the driving forces behind the nonbank bank movement is reflected in figures recently cited by Robert Litan of

the Brookings Institution in describing the competitive assault on banks and the important structural changes that are taking place in the financial services markets. Banks are losing many of their commercial loan customers, for example. Having supplied 85 percent of U.S. corporations' short- and intermediate-term credit in the 1950s, banks now provide only 60 percent of such credit, and the downward trend seems to be continuing. Nor can banks hope to make up those losses in the consumer markets, for they are no longer the primary source of individuals' credit. In 1985 consumers turned to finance companies, credit unions, retailers, and savings banks for 56 percent of their loans, up from 52 percent as recently as 1980.[8]

What has caused those changes? For one thing, companies formed as specialized lenders are branching out. Ford and General Motors operate finance subsidiaries that are no longer interested in merely extending automobile loans. Both firms' subsidiaries are now heavily involved in mortgage banking, for example. General Electric Credit Corporation has become a leading business lender and, with its recent acquisition of Kidder Peabody, is positioning itself to become a major investment banker. Furthermore, the booming securities markets have encouraged an increasing number of firms to raise funds through the capital markets rather than borrow from banks.

Fundamental structural changes are driving such developments. At their root are two sets of events: the economic upheaval and the telecommunications revolution of the last decade.

The Consequences of the Economic Upheaval

The double-digit inflation and high interest rates of the late 1970s and the early 1980s had a significant impact on the financial services markets. They created additional demand for nonbanking financial services from bank customers, thereby generating an opportunity for new suppliers of financial services to enter markets in which they had not been able to be competitive.

Specifically, with inflation soaring and interest rates rising and volatile, many individuals, whether in the course of managing their own financial affairs or their employers', began to reevaluate the service they were receiving from their banks. Often through no fault of their own, the banks were found wanting. They could not offer market rates of return on the funds traditionally deposited with them by low- and middle-income savers, nor could they offer new sources of working capital to their commercial customers. Consequently, as individuals and businesses sought to protect their interests in a period of economic uncertainty, they became accustomed to looking outside the banking community and dealing with other sources of financial services. Their financial sophistication increased accordingly.

Naturally, nonbank suppliers of financial services were happy to meet the needs of disenchanted bank customers. The results included innovations such as money market mutual funds for consumers seeking savings alternatives and commercial paper and non-investment-grade ("junk") bonds for companies seeking a less expensive source of debt capital. Furthermore, it was not only domestic financial firms that stepped into the gap created by U.S. bankers' inability to meet their customers' needs; foreign firms also eagerly contributed their services, through branches established in the United States and through the Euro-dollar and Eurobond markets.

Although inflation has subsided substantially and, as a result of regulatory changes, banks are now able to offer higher rates of return on savings, the nonbank firms that have entered banking markets are not prepared to meekly step aside. Nor are former customers of banks complacently returning to the fold. Consequently, the markets to service the financial needs

of businesses and individuals have become increasingly competitive. To retain their customers and attract new ones, financial services firms must offer attractive packages. Insured deposits, investment capabilities, access to affordable credit, and any number of other features may become part of the selection offered in the emerging financial services markets. Thus, in seeking to remain competitive, many nonbank financial companies have seized upon the nonbank bank as a means of providing a full range of services to their customers and lowering their operating costs.

A more recent source of upheaval is the uneven economic performance during the current recovery. Industries in which participants had based investment decisions on the assumption that inflation would continue are now experiencing serious difficulties. Two of those, agriculture and energy, are causing particular concern in the banking industry because of their regional concentration. Many banks are inhibited by branching restrictions from adequately

diversifying their loan portfolios and are consequently exposed to potentially devastating losses in the event of regional economic downturns.

Thus, the push among banks to expand across state lines and establish a presence in other markets through the device of nonbank banks has four motivations. First, banks are attempting to increase the diversification in their portfolios of consumer loans and thus reduce their risk of failure. Second, they are seeking to expand their base of relatively small deposits made by individuals and small businesses, which is the least expensive and most stable source of funding for banking operations. Third, banks are striving to match their competitors in the financial services industry--if not in the range of services offered, at least in the range of locations in which services are available. Finally, many banks are using nonbank banks to establish a presence in attractive locales in anticipation of expanding further after interstate barriers fall.

The Consequences of Telecommunications Advances

Telecommunications advances are playing a significant role in eliminating political boundaries (both state and national) as barriers to the flow of financial capital. More than any other industry, the network of money markets is becoming truly international in scope.

Community banks cannot hide from that fact at home. State restrictions are becoming increasingly ineffective. Not only are the barriers being assailed in state legislatures, but more and more consumers are able to use nationwide computer networks--whether at home or at automatic teller machines--to shop for and obtain banking services in the next town or the next state.

Consequently, newly chartered depositories are rethinking the traditional ways of doing business. For example, in January 1986 New England Federal Savings Bank set up shop in an upstairs Boston office. Its officials expected to operate almost entirely through the mails and by telephone. The absence of a physical branch network allows the institution to offer customers more attractive interest rates on deposits and to secure better returns for stockholders. Similarly, Greenwood Trust Company, the consumer bank owned by Sears, solicits deposits nationwide, promising savers higher returns that reflect the lower costs it incurs because of the absence of a physical branch network. There is no banking market into which such institutions cannot reach.

But it's not only individual customers that are finding more alternatives. The size of the businesses able to raise funds through the domestic and foreign capital markets is steadily decreasing as telecommunications advances allow information to be gathered and transmitted more cheaply and reduce the minimum size of transactions that can be handled easily in organized markets. The much-talked-about "junk" bonds are in fact primarily a mechanism through which mid-sized firms--not just the nation's largest corporations--are able to access the capital markets instead of being forced to raise debt capital only through bank loans. Non-investment-grade bonds allow such firms to borrow directly from lenders and reduce their capital costs in the process.

Furthermore, new communications technology is allowing an increasing number of U.S. firms to take their financial-capital needs offshore; their officials can float debt issues in the Euromarkets without leaving their offices. U.S. banks with overseas branches can earn fees by aiding their corporate customers in that process, but such income must be little consolation to them, considering that until a few years ago they were providing the bulk of the credit themselves.[9]

In short, financial markets are evolving at a pace and in directions that could not possibly have been anticipated by legislators in 1933, in 1956, or as recently as a decade ago. Financial services firms that hope to survive and prosper in that rapidly changing environment must exhibit more flexibility than was required at any other time in history. Nonbank banks represent an attempt by many financial firms to attain such flexibility. But laws and regulations written for a different era in the name of safety and soundness constrain those financial firms in a way that may in fact threaten their long-term survival. It is little wonder, then, that financial institutions of all descriptions are straining at their regulatory chains, seeking any escape. Their situation argues not for tighter chains but for a reexamination of the need to constrain them at all.

The Case against Regulation

Opponents of geographic expansion and the liberalization of banks' powers rarely mention a desire to protect the local market power of existing depositories. Consequently, the following discussion focuses on service to consumers and the safety and soundness of the banking industry.

Service to Consumers and Small-Business Owners

Among the charges of unfair competition brought by opponents of nonbank banks are that the parent companies can pay higher interest rates on deposits and charge lower interest rates on loans and credit card accounts financed through their limited-service banks. They are also said to have an unfair advantage because they can offer customers a broader range of services and wider access to funds. To whom are those practices unfair? No doubt providers of financial services that do not or cannot meet such challenges with their own innovations will be harmed, but how is that unfair to bank customers? Does the answer lie in restricting the behavior of firms that are attracting customers by offering better prices and services or in providing traditional depositories with more freedom to compete?

The latter alternative does not address concerns about an undue concentration of financial power, some will charge. As William Haraf of the American Enterprise Institute points out in an unsigned article on nonbank banks, however, those concerns have little basis in fact. If integrated financial services firms do gain market share at the expense of more-specialized institutions, it must be because they are offering a better mix of services or offering the same services more efficiently or at a lower price.[10]

In fact, in most cases competition would be enhanced by removing the current restrictions. As a rule, the financial services sector is highly unconcentrated and very competitive. The major exception to that rule is not in New York or California, where the nation's largest banks and brokers operate and can range freely throughout the state, but rather in small rural communities, where there is often only one bank. Consider how much better served residents of such towns would be if a branch of a larger bank or a Sears catalogue store could offer them banking and insurance services. Consider how much broader the ownership of corporate stock would be if banks could offer their local customers advice on and access to the stock markets. And if new firms could enter small-town markets more easily, an institution that abused customers' trust and loyalty would soon face new competition.

Sen. William Proxmire has praised the small-business community for creating new jobs and for contributing much of the current vibrancy to the economy, and he is certainly right in doing so. But his apparent assumption that we must have small banks to foster a healthy community of small businesses is misguided, for several reasons.[11]

First, serving the small-business community is becoming the bread-and-butter activity of more and more banks, regardless of size. It is nice to land a large customer, but, by definition, there are few of those, and they can be fickle. To be assured of remaining in business, therefore, most banks must concentrate on the more stable customer base provided by small-business owners. In addition, more and more large and mid-sized firms are raising debt capital through the bond markets, which further increases the importance of small-business customers to bankers. Finally, one of the surest ways for a bank to obtain larger corporate customers is to foster the growth of small local businesses.

That brings us to a second reason greater regulatory freedom would aid rather than hinder small-business development. When a successful small business grows, its financial needs change. Its owners and directors may want to issue stock. They may want to raise debt capital from more than one source. They may want to open a manufacturing or distribution facility in another state or country and may therefore require a banking presence in their new location. To whom do they turn for advice? It is likely that they turn to their local banker, who must refer them to someone else--someone who is less familiar with the history of their company. Accordingly, are we aiding or inhibiting the growth of the small-business community by maintaining the existing powers distinctions and geographic restrictions?

An issue generating increasing public concern is the role of U.S. businesses in world markets. Much has been said and written lately about the need to make U.S. goods more competitive overseas and the steps that might be taken to accomplish that goal.

It should be recognized that a major impediment to U.S. businesses' ability to enter overseas markets is the fragmented nature of our banking system. To whom should the owner of a local business--say, in Keokuk, Iowa--turn for financial advice should he learn of or seek to learn of opportunities to export his product? The manager of his locally owned and

operated bank is unlikely to be of any help in explaining how he could hedge against fluctuations in the exchange rate, for example, or how he could establish the banking relationships he needs to compete in a foreign market. Owners of foreign-based companies seeking to expand into U.S. markets, on the other hand, often find that the same bankers who wrote their home mortgages and helped them raise the capital to start their businesses can provide them with the detailed advice and the services they need to launch their American operations.

The Question of Safety and Soundness

Everyone gains from a stable banking system, but efforts to protect each U.S. bank through laws that define acceptable activities and geographic markets narrowly may be undermining rather than enhancing the system's stability. Consider some of the current problems:

* The savings and loan industry is experiencing difficulties not because of its broader powers but because of regulations requiring S&Ls to fund long-term, locally concentrated, specialized asset portfolios with short-term liabilities. Serious and costly mistakes have certainly been made by S&L officials in pursuing a wide range of new activities, but desperate gambles may seem necessary when one is attempting to recapitalize an insolvent institution.

* Banks in the farm and energy states are failing in record numbers, for the same reason that thousands of banks failed in the 1920s. The problem is not deregulation but restrictions that force those banks to bet their future on the continued economic health of narrowly defined regions. The banks cannot ride out short-term difficulties in certain sectors while continuing to provide support for the healthier elements of their communities. Their portfolios are so concentrated that losses in one sector quickly deplete their capital.

* Large banks are taking on more credit risks, and no one can predict the impact of the increase in their off-balance-sheet activities. Why those forays into unfamiliar territory? Banks are prevented by law from serving their traditional business and individual clients, who have found better-quality, more-cost-effective services elsewhere. With large and mid-sized companies raising their debt capital through the services of other kinds of financial firms, the more heavily constrained banking industry must find new activities.

There is no evidence that combining depository institutions with commercial or other kinds of financial firms under the same holding company causes systemic problems.[12] Indeed, the increased diversification that results can help stabilize a holding company's earnings and profits over the business cycle. That mechanism could therefore represent an important way for locally operated banks that do not become a part of a branching network to survive. Nondepository parent companies could be an excellent source of capital for depositories whose loan portfolios are concentrated in a single region.[13]

The very nature of its business requires the banking community to assume broader economic risks. After all, any loan, whether to a business or to an individual, carries the risk that a change in the borrower's exogenous economic circumstances--the emergence of new competitors, a reduction in the demand for a product, the loss of a job--will undermine his ability to repay his debt. There is no way to insulate the banking community from the risks faced by nonfinancial firms. Legal changes that allowed greater geographic and asset diversification would help considerably, but the risk cannot be eliminated.

Conclusion

This study is not meant to provide a framework for the financial services industry of the 21st century. Nor is it meant to suggest that the dilemmas that policymakers must resolve are simple or straightforward; many of them involve very complicated economic and public policy principles. Rather, the purpose of this study is to suggest that the dilemmas faced by the financial services industry, federal and state regulators, and Congress will not be solved by closing loopholes without at the same time addressing the changes in the domestic and international financial markets that caused the loopholes to be exploited.

What is threatening the stability of the financial services system is not limited-service banks but rather the inflexibility of a regulatory structure that was designed 50 years ago. The economic (like the physical) world is in a state of constant flux, and financial institutions (like species of plants and animals) must adapt or die. But banks are kept by

law from responding to the changes in their environment. Will the banking industry be strangled by the dead hand of Depression-era legislators?

FOOTNOTES

[1] The Supreme Court has upheld this interpretation and has prevented the Federal Reserve Board from redefining either "commercial loans" or "demand deposits" in a way that would close the loophole.

[2] The law is not absolutely clear about whether the personal loans made by nonbank banks must be confined to consumer loans--funds designated for car purchases, home improvements, and college tuition, for example--or whether they may be used by their recipients for business purposes. The ambiguity leads most limited-service banks to lend only for consumption