26. Financial Services

U.S. banking policy has been influenced from the beginning by several misplaced fears and outright myths. Legislative and regulatory reactions to those unfounded concerns have had several unfortunate consequences. For more than 200 years, for example, the fear of concentrated financial power exercised by big money-center banks was used to block interstate banking. The branching restrictions that resulted created banks with geographically undiversified loan portfolios. As a result, the United States has suffered more bank failures and regional banking crises than any other developed country. More important, instead of promoting competition, branching prohibitions inhibited it, creating thousands of local monopolies and duopolies in small towns across the country. The legislation this past year to allow interstate branching represents an important, and long overdue, step in the right direction.

Other policies arising from long-held but mistaken beliefs have had similar harmful consequences. The rhetoric and the reality of U.S. banking policy have long been in conflict. While the rhetoric has promoted competition and cursed monopolies, the reality, especially since the 1930s, has been to provide each chartered financial institution with enough market power to guarantee its survival. Banking policies have been largely aimed at limiting competition both among banks or savings-and-loan associations and between depository institutions and other types of financial institutions.

That government-created market power has meant that, in some cases, consumers have been poorly served. Given few choices, consumers demanded better service from their government representatives. Consumer protection laws aimed at correcting problems caused by government restrictions on competition were the result. In the end, of course, advances in communications and computer technologies have made many of the government-sponsored barriers to competition irrelevant—at least for the vast majority of households and businesses. But the remaining barriers to competition often unnecessarily increase costs for some market participants, and they make it more difficult for financial institutions to reach truly underserved markets.

The 104th Congress has an opportunity to rid the U.S. banking system of the more serious ill effects of regulation. To bring banking policy into line with banking rhetoric, this Congress should undertake three early initiatives:

- **Repeal the 1933 Banking Act, including the Glass-Steagall Act.**
- **Repeal the Bank Holding Company Act.**
- **Repeal the Community Reinvestment Act.**

1933 Banking Act

Widespread bank failures, the collapse of the stock market, and a depressed economy gave rise to the feeling that something needed to be done, and the 1933 Banking Act was the result. The act had two major components: it introduced federal deposit insurance for banks, and it forced the separation of commercial and investment banking. But neither component of the bill addressed the economic ills of the 1930s, and neither is necessary today. The Banking Act of 1933 should be repealed.

Federal Deposit Insurance

The bank failures of the 1930s were caused primarily by restrictions on branching. All but 10 of the 9,000 banks that failed during the early 1930s were single-office banks. The Roosevelt administration thus supported more liberal branching laws as a solution to the industry's ills. Members of Congress from states with the most restrictive branching laws opposed Roosevelt's interstate banking proposal and promoted federal deposit insurance in its place.

Federal deposit insurance has had substantial costs, however. For insured depositors, government deposit guarantees substitute the credit standing of the federal government for the financial strength of all insured banks. There is little reason to question a bank's financial strength or its investment strategies. Depositors, quite rationally, look for the highest interest rates instead.

Freed from depositor constraints on their behavior, bank managers can attempt to increase stockholders' returns by reducing capital and increasing the returns promised from their investments. Of course, the risk of failure also increases. The federal government, as the creditor of last resort, must then take steps to monitor banks' and savings-and-loans' and credit unions' capital and investment activities. The federal government must be prepared to close institutions in a timely manner. The federal government's intrusion into the banking business (especially since passage of the Federal Deposit Insurance Corporation Improvement Act of 1991) is a direct result of deposit guarantees.

But government examiners, however well intentioned, are not market participants. They are not the best judges of which loans represent sound credit risks and which do not. They are not the best judges of when forward or swap contracts reduce risk, when they represent sound investments, and when they become part of a dangerously risky portfolio. Further, government regulation and control inevitably lead to pressures to allocate credit to politically favored groups—developing countries in the early 1980s or inner-city neighborhoods in the 1990s.

The economy would be better served by a banking system that was no longer dependent on, or held back by, federal deposit insurance. Uninsured depositors would be stricter regulators than government examiners. Failure rates were lower, and capital higher, among uninsured financial institutions during the 1980s than among government-regulated and government-insured depository institutions. Market-based regulators are also more adaptable. An innovation acceptable to depositors at one bank might—or might not—be acceptable elsewhere. Experimentation, and hence efficiency, in the banking markets would increase, and bank customers would be better served.

The Glass-Steagall Act

Similarly, the legal separation of commercial and investment banking should be eliminated. There was no link between banks' securities activities and either bank failures or the collapse of the stock market during the 1930s. Of the 145 banks with relatively large bond departments in 1929, only 11 closed during the Depression, and despite extensive congressional hearings, supposed stock market abuses were never proved. Further, the Glass-Steagall Act appears to have been designed to limit competition in both the investment banking and the commercial banking industries. (Excessive competition was blamed for the bank failures that occurred.) The Glass-Steagall Act, part of the Banking Act of 1933, was an inappropriate response in the 1930s, and it serves no purpose now.

Banks in other developed countries engage in both commercial and investment banking activities with no ill effects. Indeed, U.S. banks operating in other countries engage in investment banking activities without apparent harm. Allowing U.S. commercial banks to engage in investment banking activities—and investment banks to engage in commercial banking activities—would increase potential competition across the board. Repeal of the Glass-Steagall Act would also increase the flexibility of the commercial banking industry, allowing it to respond to competitive threats and better serve its customers.

The Glass-Steagall restrictions should, however, be removed with care. Some minimal safeguards are needed to protect the deposit insurance fund (as long as it exists), but replacing current Glass-Steagall prohibitions with impenetrable firewalls that prevent cross-selling and other information-driven synergies would harm both banks and their customers.

Bank Holding Company Act

The Bank Holding Company Act, passed in 1956 and amended in 1970, grew from the same fears as did restrictions on branching. Indeed, one goal of the legislation was to stop interstate banking by another name. Other goals were to prevent banks from engaging in nonbanking activities (such as investment banking, insurance, and real estate transactions) and to stop nonbanks from entering the banking market through holding company structures.

Here again, limits on competition are couched in "fear of concentration" terms. Today the financial services market is more competitive and dynamic than at any time in our history. Nonbank financial providers, including subsidiaries of several large industrial firms, offer financial products that are close substitutes for banks' services. Banks should be allowed to compete by offering a full range of financial products and services. The Bank Holding Company Act should be repealed.

Community Reinvestment Act

The Community Reinvestment Act was passed in 1977. That act, desired by community activists, gave legal embodiment to the idea that banks have an obligation to invest deposits in their local communities rather than where they can earn the highest return.

Enforcement of the act has been largely subjective, and thus often uncertain. CRA evaluations have gained added weight in recent years as they have been used to determine whether banks will be allowed to open new branches or merge with other institutions. In some cases, complaints from community groups about CRA noncompliance have begun to look like extortion efforts as community groups have named specific investments as the "price" of dropping their complaints and allowing banks to pursue needed structural changes. But attempts by the Clinton administration to make CRA compliance more "clear and objective" have led regulators down the path toward lending quotas. That may be the inevitable result of any effort to require a "bright line" test of adequate service to a particular community.

The Community Reinvestment Act should be repealed. (It might be noted that the CRA does not outlaw credit discrimination on the basis of race, gender, national origin, marital status, or age, which are the subject of the separate Equal Credit Opportunity Act.) Changes in the financial services industry over the past 15 years have made it increasingly difficult to define a bank's territory, and increased competition from mortgage bankers, finance companies, and other financial service providers has largely eliminated the financial hold banks once exercised over some communities. Most important, however, the CRA may be doing more harm than good in the communities it purports to serve.

Bankers' first obligation is to their depositors, not to borrowers. Money deposited with a bank never leaves the community, regardless of where it is invested, because depositors continue to have access to their funds. Bankers who protect their depositors' interests by providing higher returns or safer investments are promoting the economic welfare of the community by maximizing the wealth of deposit customers and giving them more money to spend in their communities.

The interests of consumers are best served by competition in a dynamic marketplace. That is especially true for consumers in lower and lower middle income groups. There are always plenty of merchants and financiers eager to serve the wealthy. It is often left to the more innovative newcomers, the smaller (and hungrier) institutions, to search out underserved groups and find profitable new ways to bring products and services to those families and small businesses.

That market-driven process requires that new financial institutions be able and willing to set up shop. The high costs associated with CRA requirements make it more difficult for a new bank to enter the market, even if the bank wants to serve a poor community. As a consequence, inner-city poor communities are often dependent on check-cashing outlets and pawn shops rather than full-service banks.

The best way to encourage the flow of financial resources to poor communities is to encourage entry. For much of the period since the Depression, government policies have discouraged new entry. One of the most important ways to ensure that financial services spread to underserved communities is to liberalize chartering and branching requirements. Increasing the competitive pressures banks face will lead them to search out new customers.

Conclusion

A couple of things should *not* be done. Congress should not rush headlong toward consolidating the bank regulatory agencies. Competition among regulators has almost certainly led to more adaptable regulation, and hence a more innovative banking system, than would have occurred otherwise. Streamlining the system so that each banking organization chooses one regulator would reduce costs and increase accountability without giving up the benefits of continued competition.

We do not need legislation to "deal with" derivatives. First, the risks associated with derivatives are not fundamentally different from the risks associated with the underlying assets. Financial institutions manage such risks every day, and if there are problems, it is the risk management techniques that are at fault, not the instruments themselves. Second, news reports focus on the few people who lose money through derivatives investments. We hear less about the thousands of companies and investors who reduce their risks through the hedging opportunities offered by futures, options, swaps, and other derivatives.

In short, the new Congress can best serve the interests of bank customers and the broader economy by removing outmoded barriers to competition within the financial services industry. Increased competition may mean more failures, but as long as failures are dealt with promptly (preferably by the market), they need not harm the economy or the communities where they occur. Such changes would position the U.S. financial system to better respond to consumer demand and new opportunities.

Suggested Readings

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