31. Financial Services

Congress *should*

- repeal the Bank Holding Company Act and merge the commercial bank and thrift charters,
- repeal the Glass-Steagall Act,
- privatize banking regulation and its attendant deposit insurance and systemic risks, and
- repeal the Community Reinvestment Act.

The Need for Banking Reform

In the 1980s Congress phased out depression-era controls on deposit interest rates, thus giving bank customers higher returns on their savings. And in 1997 the lifting of the remaining restrictions on interstate branching will give customers access to their accounts across state lines. But those boons are only a hint of the benefits to be reaped by peeling away remaining government banking regulations. Consumers could benefit from a system that more efficiently met their needs for borrowing to purchase houses, cars, and consumer goods; saving for their children's college educations or for their own retirement; and insuring themselves against accidents or illness. Businesses, too, will benefit from modernizing the financial system.

The computer and telecommunications revolution is changing the financial services industry by erasing the traditional lines of demarcation between various types of financial services providers. It has become increasingly difficult to differentiate banking, insurance, and securities products and services. The capacity to quickly acquire, process, and integrate economic and financial information will provide enormous benefits to consumers. For example, car loans and insurance could be packaged at a great savings in time and money for car buyers, just as buyers have

long been able to purchase vehicles equipped with tires, batteries, and other accessories.

But outdated and costly regulations have spurred "regulatory arbitrage," the lawful yet often costly avoidance of obsolete regulations by innovators in the financial services industry. Regulatory reform clearly is needed.

Unfortunately, such reform went nowhere in the last Congress. The House Banking and Financial Services Committee attempted to launch the reform of the 1933 Glass-Steagall Act that separates commercial from investment banking. That bill would have allowed bank holding companies to further penetrate the securities business. That pleased some large banks, but others have little immediate interest in getting into the securities business and thus did not exert much political pressure in favor of this reform. Further, small banks wanted the freedom to offer insurance, but insurance agents strongly opposed that reform. The 105th Congress almost certainly will have to address those issues.

Repeal the Bank Holding Company Act and Merge the Commercial Bank and Thrift Charters

Commercial banks and thrift institutions (that is, savings-and-loan associations and savings banks) operate under separate charters. Both have been restricted in the kinds of services they can offer customers. Combining their charters would permit a depository institution to offer its customers a broad range of fully integrated banking products and services. Since 1989 Congress has eliminated most of the regulatory distinctions between banks and thrifts; marketplace distinctions between those two types of institutions also have diminished greatly.

But one big problem still remains. Today, commercial banks can be owned either by individual stockholders or by corporations. But corporations owning commercial banks must register with the Federal Reserve Board as "bank holding companies," or BHCs, under the Bank Holding Company Act. While stockholders can, as individuals, engage in any other business activities that they wish, BHCs can engage only in activities that are "closely related to banking," a term that the Fed traditionally has defined quite narrowly. Thus, neither General Motors nor Microsoft nor a major insurance company can own a commercial bank since their principal activities are not closely related to banking. (There are a few limited-use exceptions to this rule.) Only in recent years has the Fed permitted BHCs to begin to enter the securities business, but BHCs are still barred from offering most types of insurance as well as participating fully in other

types of financial services activities. Most thrift institutions, on the other hand, operate under an entirely different holding company law that essentially permits anyone, including, for example, insurance companies, auto manufacturers, and day-care providers, to own a thrift.

Congress will be under political pressure to merge the bank and thrift charters, in part because it directed the Treasury Department to recommend how they could be combined. If those charters are not merged properly, the merger will force corporate owners of thrifts to qualify as BHCs or divest their thrifts. The merger presents Congress with a major challenge: does it charter up or charter down? Chartering up means creating a new depository institution charter that combines the best features of the bank and thrift charters, and then some; chartering down means imposing unnecessary restrictions on depository institutions. Thus, instead of allowing more financial institutions to offer more services to customers, regulatory changes could stifle competition and limit consumer choice.

Congress can avoid those problems, first, by repealing the Bank Holding Company Act, thus permitting anyone to own a bank regardless of the other businesses in which he or she may be engaged, and, second, by creating a new depository institution charter that combines the best features of the commercial bank and thrift charters. Interestingly, the elimination of federal restrictions on interstate banking, which becomes fully effective on June 1, 1997 (except in Texas), eliminated one of the initial rationales for the Bank Holding Company Act.

Repeal the Glass-Steagall Act

The debate over the future of bank and thrift charters as well as the holding company acts probably will be subsumed under a broader debate over financial services policy. The Glass-Steagall Act, passed as part of the Banking Act of 1933, separated commercial and investment banking. Ideally, Congress should repeal Glass-Steagall. But bank regulators are taking steps in that direction whether Congress acts or not. The Office of the Comptroller of the Currency regulates commercial banks registered at the federal level, called "national banks." It has just issued new rules to clarify long-pending questions concerning the powers of those banks, under the so-called operating subsidiary, or "op-sub," regulation. The "powers" debate addresses the activities in which a federally insured bank or thrift is permitted to engage. The "affiliations rights" debate addresses the question of who can own a depository institution and what else that owner can do. Currently, different affiliates of a bank holding

company can offer commercial or investment banking services, but not both. However, a subsidiary of a commercial bank can offer only services "incidental to banking."

The comptroller's new op-sub regulation will permit national banks, or their subsidiaries, to seek permission from the comptroller to offer a broad range of financial services, notably insurance and securities, that in some cases are not even permissible to BHCs. In effect, a broad interpretation of existing banking law would permit the emergence in the United States of the "universal bank" like those now found in many other industrialized countries, including Germany and Great Britain. The Supreme Court, in four unanimous decisions within the last two years, has affirmed the comptroller's power to broadly interpret existing law when his office rules on applications by banks seeking to engage in new activities, provided the comptroller can make a "reasonable" case for his interpretation. Hence, the comptroller, if he so desires, could substantially repeal the Glass-Steagall Act by regulation.

The comptroller should enable commercial banks to shed the limitations that the Fed places on BHCs, because the universal bank form of organizational structure is more efficient for most banking organizations than the BHC form. Since almost all American commercial banks with more than $1 billion of assets are owned by BHCs, the comptroller could revolutionize the structure of the American banking industry within a few years.

But that new freedom will be a one-way street. While commercial banks will be free to offer many services, nonbank firms such as securities and insurance companies and mutual fund managers will be barred from directly entering the banking business.

Nonbanks will not want to own banks through a holding company structure because it would burden them with the inefficiencies associated with such a structure. Hence, the comptroller's broadening of the powers of national banks may force the 105th Congress to authorize the "universal financial services firm," which would permit securities, insurance, and mutual fund companies to directly own banks.

The Need for Further Reform

Permitting closer affiliations between banking and other types of financial services will force Congress to address several federal financial safety net issues. The federal financial safety net consists of federal deposit insurance; the Fed's role as lender of last resort to the entire financial system; and the central role that the Fed plays in the U.S. payments system,

that is, clearing checks and electronic payments between banks. In addition, the states have created "guarantee funds" to protect insureds against insurance company insolvencies.

Depositors are protected by federal deposit insurance, up to $100,000, if their bank or thrift fails. In return, banks and thrifts are subject to heavy-handed government safety-and-soundness regulation, and they pay supposedly risk-sensitive deposit insurance premiums that in fact are not very risk sensitive.

Despite the savings-and-loan debacle, Congress did not reform deposit insurance when, in 1989, it committed taxpayer funds to clean up that mess. As an alternative to deposit insurance reform, in 1991 Congress toughened bank and thrift regulation. Those "reforms" represented an expansion of the federal government's police power over banks and thrifts; no attempt was made to introduce market-driven regulation or to privatize deposit insurance. Ironically, Congress also expanded the Fed's lender-of-last-resort function by making it easier for the Fed to lend to nonbank financial firms.

Permitting greater integration of financial services will overwhelm banking regulators. Their one-size-must-fit-all approach to regulation and compartmentalized structures are inappropriate for financial services firms pursuing widely varied business strategies that integrate the banking function with other types of financial services. Congress will be forced to consider more far-reaching concepts for ensuring the safe-and-sound operation of more varied financial institutions while maintaining stability in the financial system and providing loss protection for at least small depositors.

Privatizing Regulation

The financial markets already possess the means for self-regulation. One means is market-determined covenants and other contractual restrictions in bonds that corporations sell to investors, in loan agreements, and in insurance. Another means is risk-sensitive interest on loans as well as risk-sensitive premiums for insurance.

Congress could easily expand the use of contractual regulation. For example, it could require all financial services firms that accept deposits, provide insurance, or directly access the payments system to negotiate a "safety-and-soundness" contract with a private-sector entity that would monitor the financial services provider's compliance with the terms of its regulatory contract and protect depositors and insureds against any loss should the financial services firm become insolvent. Such a contract would

specify the prudent practices to which the firm would agree to adhere in order to operate in a safe-and-sound manner. The monitoring firm's fee undoubtedly would be risk sensitive, reflecting the financial institution's probability of failure. The private sector could easily assume this most important function, which government bureaucrats have performed badly.

Shifting banks and other financial services providers to contractual regulation would benefit the American economy in two ways. First, individual firms would be able to negotiate prudent operating practices and safeguards tailored to their business strategies. Today, the business strategy of banks, thrifts, insurers, and other highly regulated firms is largely shaped by regulation. Tailor-made private regulations would make financial services providers more competitive and better equipped to serve their customers. For example, privately regulated financial firms would have sufficient operating flexibility to serve specialized markets, such as low-income and minority communities.

Contractual regulation also would benefit the economy by sharply lessening the herd tendencies of highly regulated banks, thrifts, and insurers that have created periodic financial disasters. Regulation, like taxation, greatly distorts business behavior because strategic planning in highly regulated firms is shaped to a great extent by what is permitted by government regulation. Contractual regulation, however, would give individual financial services firms much greater latitude to differentiate themselves from their competitors because they would be operating under regulatory strictures that they helped to design. Differentiation, which characterizes the strategies unregulated industries pursue, would produce fewer failures and lower insolvency losses because at any one time only a few firms, not an entire industry, would be pursuing business strategies that might eventually produce losses and even bankruptcy.

Privatizing Deposit Insurance

Requiring private-sector regulator-guarantors to protect depositors, insureds, and others would lead to the privatization of deposit insurance. Three aspects of this issue are worth considering.

First, a banking firm cannot switch to contractual regulation if it wants to operate without any deposit insurance. As a practical political matter, Congress will not allow any financial institution that takes deposits or provides insurance to operate without some kind of loss protection for depositors and insureds. Absent the alternative of no regulation, market-driven contractual regulation is, for all concerned, preferable to uninsured

firms still subject to heavy-handed and increasingly counterproductive government regulation.

Second, the providers of contractual regulation could not attempt to shift some of the cost of their errors to large depositors and other creditors of the institutions they regulated. That is because any attempt at such cost shifting could trigger massive bank runs that would destabilize the financial system. Consequently, private-sector regulators should guarantee all deposits, and not just the first $100,000 per customer, which today is the limit for federal deposit insurance, unless a bank is too big to fail (TBTF). TBTF is a reality in the industrialized world because the sudden liquidation of a large bank, insurer, or securities firm could destabilize the financial system. In TBTF situations, other financial firms and even the general taxpayer are taxed to protect creditors who are not protected in smaller failures. Consequently, as a practical matter, deposit insurance limits apply today only to depositors in smaller banks, which is highly unfair. A private regulatory mechanism would allow protection of all deposits and insurance obligations in all financial firms and thus would eliminate that unfairness and ensure financial stability.

Third, any regulatory process—government or private—should protect taxpayers against losses arising from regulatory failures. That clearly did not happen in the S&L crisis, nor does it happen under government deposit insurance and insurance guaranty schemes when healthy institutions are taxed to pay for losses arising from regulatory failures. Consequently, Congress's modernization of the structure of the financial services industry must be accompanied by deposit insurance and regulatory reforms that provide failure-proof taxpayer protection.

One way that privatized regulation could ensure financial stability without taxpayer risk is through "cross-guarantees." Banks and thrifts could enter into regulatory contracts with ad hoc syndicates of private-sector guarantors, largely other banks and thrifts. Guaranteed institutions would pay a risk-sensitive premium to their guarantors for protecting depositors and others against loss should the guaranteed institution fail. The guarantors would then use an independent firm to monitor the guaranteed institution's compliance with the terms of its cross-guarantee contract. Risk-spreading rules applicable to each contract would protect taxpayers against deposit insurance losses even in conditions worse than the Great Depression.

As an added plus, cross-guarantees would liberate Congress from having to decide who could do what within the financial services arena. Instead, the activities and affiliations of individual guaranteed firms could be addressed

entirely through their cross-guarantee contracts. The commercial marketplace, not the political marketplace, would then shape the structure of the financial services industry.

No doubt there are other ways the private sector could guarantee deposits and privatize regulation. It is time for Congress to begin exploring such approaches.

Repeal the Community Reinvestment Act

Congress has loaded substantial welfare obligations on banking, notably through the Community Reinvestment Act. While the CRA reads fairly innocuously, regulations adopted under it increasingly compel banks and thrifts (but not untaxed credit unions) to subsidize their lending and other banking activities in low- and medium-income and minority communities.

Supporters of the CRA claim that it is fair because banks and thrifts receive federal deposit insurance, which the supporters claim is a subsidy that flows from taxpayers to banks and thrifts. In fact, federal deposit insurance has subsidized ineffective government regulation, and much of that subsidy has been paid by healthy institutions in the form of punitive regulation and higher deposit insurance premiums than they would pay in the commercial marketplace.

The CRA is not intended to deter discrimination against individuals. Instead, it is a credit allocation device designed to funnel loans into neighborhoods and communities thought to be underserved by banks and thrifts. However, any such market failure reflects the distortions caused by government regulation. Shifting banks and thrifts to private, contractual regulation would permit those institutions to adopt more differentiated business strategies than is possible today; consequently, some depository institutions would find it quite profitable to serve low-income and minority communities, thus obviating the need for the CRA. Furthermore, as technology fosters increased opportunities for regulatory arbitrage, it will become increasingly difficult for Congress to safely impose social welfare obligations on those institutions that it can still snare in its regulatory web.

Conclusion

Rapid technological change demands fundamental regulatory reform in the financial services industry, to reflect both the eroding distinctions among various types of financial products and financial services providers and the irreversible decline in the efficacy of traditional government safety-

and-soundness regulation. Financial stability and protection of the proverbial "widows and orphans" among depositors and insureds will continue to be valid political concerns; however, government regulatory micromanagement of banks, thrifts, insurers, brokerage firms, and mutual funds no longer can provide that stability and protection. Attempts to restore the efficacy of government regulation will merely impair the efficiency of financial services firms; Humpty-Dumpty cannot be put back together. As part of broader privatization initiatives, the 105th Congress should shift individual financial firms to private, contractual regulation, thereby permitting the marketplace to determine what constitutes prudent banking as well as the specific activities in which individual firms are engaged.

Stripping away government regulation of banking would help both consumers and businesses. Consumers would be able to obtain a mix of financial services tailored to their individual needs for less cost and with greater security than is currently the case. Businesses could more easily acquire loans, insurance, and capital, all necessary for operating in a more competitive and integrated world economy.

But those benefits will only be realized if government steps aside and allows banks and customers to manage their own affairs. Financial institutions in other countries often are freer than those in America, putting many foreign firms at a competitive advantage over American ones. It is time to establish a level playing field by removing counterproductive regulation of American banks.

Suggested Readings

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Petri, Tom, and Bert Ely. "Better Banking for America: The 100 Percent Cross-Guarantee Solution." *Common Sense* (Fall 1995): 96-112.

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