25. Financial Deregulation

Congress should

- extend the Gramm-Leach-Bliley Act (1999) to all banking institutions and remove Community Reinvestment Act compliance;
- repeal the Community Reinvestment Act (1977) to allow fair and competitive lending while eliminating the unnecessary burden of paperwork imposed on banking institutions and regulatory agencies;
- eliminate mandatory federal deposit insurance, allow competition, and privatize the Federal Deposit Insurance Corporation; and
- enact the Bankruptcy Reform Act with stronger provisions to prevent those debtors who can repay their obligations from abusing the system.

Gramm-Leach-Bliley Act: A Good Start in Need of Fine-Tuning

The 106th Congress did a favor to consumers of financial services by passing the Gramm-Leach-Bliley, or Financial Modernization, Act of 1999, which repealed much of the Glass-Steagall Act (1933) and the Bank Holding Act (1956) and removed many of the artificial barriers separating insurance companies and commercial and investment banks.

Allowing firms to transform themselves into financial holding companies that can engage in a wide range of financial services will give rise to more competition, and consumers will benefit from lower prices, one-stop financial services, and innovation leading to more products. U.S. firms will be better able to compete globally.

The act also lessened restrictions on merchant banking by allowing financial holding companies to make larger equity investments in nonfinancial companies without ownership limitations. However, restrictions

remain on financial holding companies' ability to control the corporate governance and management activities of the nonfinancial companies in which they invest. Congress should go further in allowing financial holding companies to directly manage their investments.

Assets of the financial subsidiaries of national banks cannot exceed 45 percent of consolidated assets. Financial subsidiaries of national banks remain restricted from providing insurance, underwriting annuities, investing in and developing real estate, and some merchant banking activities. Newly created financial holding companies can own banks, and their nonbank subsidiaries can engage in the wider variety of financial services that national banks cannot. That seems to be a top-down approach favoring larger institutions. The act should be extended to all financial institutions to allow them to provide consumers with a wide range of financial services.

Another provision of the act can be improved. Banks and new financial holding companies are restricted from engaging in new activities or making acquisitions unless they or their insured depository subsidiaries hold at least a satisfactory Community Reinvestment Act rating. This attempt to expand CRA compliance is unnecessary. A financial holding company with large resources could otherwise help small banks fund community lending by acquiring them and providing capital, but if the holding company has many banking subsidiaries and one happens not to have a satisfactory CRA rating, the financial holding company is prevented from doing so.

The Community Reinvestment Act

The Community Reinvestment Act (1977) was intended to encourage banking institutions to increase lending in low- and moderate-income neighborhoods within the communities they service. Federally insured financial institutions are subject to CRA rating by one of four federal agencies—the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation—with data also made publicly available by the Federal Financial Institutions Examination Council. Banks must collect a multitude of lending data and report them to these various regulatory agencies.

An institution's CRA rating is based on the number and quantity of loans originated to below-the-median-income persons, loan activity in low-income neighborhoods, and loans for community and economic development, along with demographic and economic data on the bank's geographic

assessment area—that is, the area where it does business. Banks are then given one of four ratings: outstanding, satisfactory, needs improvement, or substantial noncompliance. Data on individual institutions are made available to the public.

The CRA has few teeth to achieve its goals since there are no fines or penalties for low CRA ratings. Information collected for CRA ratings does create a database for class-action lawyers to use in suing banks servicing low-income areas. An unsatisfactory CRA rating does prevent a bank from merging or being acquired. Mergers must not harm CRA ratings, which complicates and delays the regulatory approval process.

After all the work banks and regulatory agencies do to comply with CRA paperwork requirements, 98 percent of banks receive satisfactory ratings or better. It is an elaborate and time-consuming exam process in which everyone receives an A, the equivalent of creating taxpayer-financed inspection stations for exhaust emissions and compelling new car buyers to waste time having inspected low-polluting cars that will undoubtedly pass. CRA data collection and reporting impose an unnecessary and costly burden on banking institutions and waste the resources of the federal regulatory agencies that administer the paperwork at a cost to taxpayers who fund them.

The CRA also imposes a larger cost on society by misallocating capital. In the absence of government intervention, credit markets efficiently allocate funds on the basis of risk and return. High-risk borrowers are charged higher interest rates to compensate lenders for the increased likelihood of nonpayment. Borrowers with a low probability of default borrow on more advantageous terms. To remain competitive, banks have devised sophisticated models for rating borrowers and allocating funds. That does not mean that low-income or high-risk borrowers are excluded from credit markets. Banks are willing to extend credit to any group if such loans, on average, are profitable.

The CRA causes a misallocation of capital among borrowers because it forces banks to increase their volume of high-risk loans in target areas, which can lower bank profitability. At the margin, to increase volume, banks must either take on less-creditworthy borrowers or charge those borrowers below-market rates.

The Gramm-Leach-Bliley Act in part directed the Federal Reserve to conduct a study of the relative performance of CRA lending. The Fed analyzed bank loan data subdivided into home purchase and refinance loans, which represented 80 percent of origination volume and of which

10 percent were CRA-related small business loans, home improvement loans, and community development loans. The Fed found that for overall home purchase and refinance lending, the majority of bank lending activity, 99 percent of loans by total loan amount were profitable or marginally profitable, with only 1 percent categorized as break-even. In contrast, of similar CRA-related loans, only 85 percent were profitable or marginally profitable and 15 percent were unprofitable, marginal unprofitable, or break-even. The Fed found similar results for relatively less profitable CRA-related small business loans compared to overall small business lending, which represented 16 percent of total bank originations, and the same for home improvement loans. CRA community development loans (mainly to nonprofits) did not have a non-CRA equivalent.

The CRA lowers the profitability of banks and the global competitiveness of U.S. financial institutions. Contrary to its goals, the CRA could also hurt low-income communities because, to remain competitive, banks might close branches in those communities to reduce their CRA assessment area and unprofitable CRA lending exposure, or avoid opening new branches in poor neighborhoods. It is absurd that the largest Internet bank, E-Bank (formerly Tele-Bank), which has no true branch offices, has to comply with CRA paperwork requirements. Legislation such as the CRA Modernization Act of 2000 (H.R. 4893), which would expand the CRA to the securities and insurance industries, would further increase paperwork costs and impede the free flow of capital. That legislation should be laid to rest, and the Community Reinvestment Act should be wholly repealed. Consumers and the economy would benefit as a result.

Federal Deposit Insurance: Unnecessary and Outdated Depression-Era Legislation

Federal deposit insurance is a tax on bank deposits that forces consumers to involuntarily purchase unnecessary government-provided insurance at government-set rates. Born of the Great Depression as temporary legislation later made permanent, government deposit insurance was intended to maintain consumer confidence and prevent bank runs, but modern financial institutions are better diversified and less at risk than were financial institutions during the Great Depression.

Insurance creates what economists call "moral hazard." If a house is fully insured against fire or theft, a homeowner at no risk of loss is less likely to take precautions, such as putting a cigarette out or locking the door when leaving the house. That increases the likelihood of actual

property damage and losses. The same is true of deposit insurance. If depositors know that the government will bail them out if their depository institutions go under, they will be less prudent in selecting where to place their funds. They will seek the highest returns without due regard for the increased risk. Federal deposit insurance can actually increase risk exposure and undermine financial stability. Not-at-risk insured depositors place funds in unsound banks that engage in imprudent loan activity, which produces a misallocation of capital among banking institutions and weakens the entire banking system.

Private insurance markets have ways to mitigate moral hazard. Higher premiums for those who choose higher risks alter behavior. For example, higher fire insurance premiums for those with outdated fuse boxes provide an incentive for homeowners to install modern circuit breakers. Similarly, moral hazard is mitigated with cost sharing through deductibles, or only partially insuring the risk, thus making consumers bear a portion of it. For banks, that would mean that those choosing to hold riskier loan portfolios would be charged higher insurance premiums, or depositors would have some risk exposure with partial liability or reduced insurance limits. Congress did just the opposite in 1980 by arbitrarily raising the coverage limit from $40,000 to $100,000, thus worsening the moral hazard problem while increasing the risk exposure of FDIC insurance funds and taxpayers.

Taxpayers are significantly exposed to the potential bailout of insolvent government insurance funds. Mandatory deposit insurance causes capital to flow to unsound banking institutions that fund overly risky or inappropriate projects, which weakens the banking sector as a whole and increases the probability and extent of a taxpayer bailout. The savings-and-loan debacle cost taxpayers about $200 billion in payments to depositors insured by the insolvent Federal Savings & Loan Insurance Corporation (FSLIC), nearly $2,000 per taxpayer.

Mandatory deposit insurance is outdated and unnecessary. A widespread banking panic has not occurred since the 1930s, and that collapse was largely brought about by imprudent government policy, especially the Fed's not acting to halt the sharp contraction of the money supply and the absence of interstate banking. The last time major bank runs occurred in the United States was during the months before FDR was inaugurated. Depositors, speculating that FDR would devalue the dollar against the gold standard to inflate prices, raced to withdraw funds and convert dollars into gold coin and bullion at the old rates. The last bank panic was caused

more by FDR's attempt to "fix" the economy by changing the gold standard to inflate prices and less by fear that banks were insolvent. The United States long ago abandoned the gold standard. The banking sector 70 years ago was mainly composed of small banks, many with just a single branch office dependent on local lending and economic conditions. Legislative reforms such as the Neal-Riegle Interstate Banking Act of 1994 have allowed the expansion of interstate banking. Modern banking institutions are larger with geographically diversified portfolios less exposed to regional economic downturns.

Financial innovations have also allowed banks to reduce risk. Banks can hedge with derivatives against abrupt changes in interest rates that would otherwise adversely impact bank assets. Sophisticated financial models enable banks to purchase portfolio insurance. Financial instruments can protect spreads and limit risk from mortgage prepayment. Today's banks are less at risk because they hold pooled mortgage-backed securities. Small banks of yesteryear borrowed short from depositors and lent long, holding the local home mortgages they originated to term. Their assets were composed of illiquid and geographically undiversified loans, which made it difficult to raise cash if needed to finance depositor withdrawals. Modern banks typically do not hold to term the mortgages they originate. Instead, they sell their loans to institutions such as Fannie Mae and Freddy Mac that pool them, creating diversified liquid securities. Banks and other financial institutions then purchase those "securitized" products. Bank portfolios have changed. Modern banks are much better diversified, which limits the risk of insolvency, and, by holding liquid assets instead of illiquid locally originated loans, banks can now more easily raise funds to meet the demands of depositors without closing doors.

The probability of a banking panic is more remote today because of innovations in the banking industry, not because of the FDIC and mandatory government-run deposit insurance. There is little reason to expect systemic depositor withdrawals. In fact, slow withdrawals isolated to substandard banking institutions in small doses are beneficial to the health of credit markets. Deposit insurance, meanwhile, increases moral hazard, because not-at-risk depositors have little incentive to steer their funds away from unsound and ailing banks that promise higher returns toward sound and healthy banks. Instead of private markets gradually stopping the flow of funds to inefficient financial intermediaries, government is left in control to abruptly end a bank's operations after a misallocation of capital that otherwise might never had occurred.

The government tried to mimic private markets to mitigate the moral hazard problem with the Federal Deposit Insurance Corporation Improvement Act (1991), which directed the FDIC to establish a risk-based premium system to fund its reserves. Prior to that act, banks had paid a uniform annual rate ranging from 3.3 to 8.3 cents per $100 of insured deposits. The FDIC now charges individual banks different rates with premiums based on whether the bank is well capitalized, adequately capitalized, or undercapitalized. Those capital groups are further subdivided into three categories: (1) banks that are financially sound, with only a few minor weaknesses; (2) banks with weaknesses that, if not corrected, could result in a significant deterioration and increased risk for the FDIC's bank insurance fund; and (3) banks with substantial probability of causing loss to the insurance fund.

The premium depends on capitalization and riskiness of bank assets. Under the new system, premiums would rise during economic downturns. Risk-based premiums intended to provide incentives for banks to have sound capitalization and hold less risky portfolios are countercyclical. If insurance losses caused the FDIC's insurance fund relative to insured deposits to fall below the statutory 1.25 percent minimum reserve level, the FDIC would be forced to raise assessment rates. The FDIC itself said in August 2000 that "all banks would be forced to pay substantially higher premiums at a time when many banks were under stress. . . . The system in place today, in contrast, amounts essentially to charging nothing in times of prosperity, and a lot in times of adversity, thereby potentially magnifying swings in the banking cycle."

The FDIC insures nearly $3 trillion in deposits with a $40 billion fund. The 1.37 percent reserve level (March 2000) is just above the statutory minimum. The FDIC's reserves can absorb small losses and pay depositors during economic prosperity, but they would not be able to withstand a major economic downturn. If the FDIC failed, taxpayers would face a huge potential liability that would dwarf the FSLIC bailout from the S&L crisis. The $100,000 per account depositor insurance is fictitious and only as good as the implicit taxpayer bailout. Potential taxpayer liability could be limited, and financial soundness of the FDIC improved, by lowering the mandatory insurance limit. Proposals to double the limit to $200,000 would unnecessarily increase insured deposits by $400 billion, and premiums would need to rise 23 cents per $100 in deposits to keep the insurance fund above the 1.25 percent statutory minimum.

The end of federal deposit insurance is also justified by consumer choice. Depositor insurance is mandatory, not voluntary. Consumers should be

free to purchase insurance or to deposit funds in either uninsured or insured banking institutions. Some consumers would be willing to take on more risk with uninsured deposits to reduce the implicit FDIC tax on the interest they earn. Competition has driven many people from insured bank deposits to other liquid financial instruments such as money-market mutual funds that, despite being uninsured, are low risk because of diversification and short-term lending. Some observers assert that money-market mutual funds have an unfair advantage and that mandatory insurance on deposits should be extended to those financial products plus the more than $42 billion in municipal deposits. Consumers have chosen to shift financial assets away from insured bank deposits and CDs and into mutual funds and equities. Bank deposits now make up only 12 percent of household financial assets compared to 25 percent in the mid-1980s. Congress should not extend mandatory insurance to other types of deposits and substitutive financial products, nor should it increase the $100,000 insurance limit. Such measures would unnecessarily worsen the moral hazard problem, increase the risk exposure of FDIC reserves and taxpayers, and limit consumer choice. The solution is to phase out the mandatory government-run deposit insurance program and replace it with a private, voluntary system that gives consumers a choice and more efficiently allocates capital, thus producing healthier banking institutions.

Competition should be allowed, and the FDIC should be privatized. Private mortgage insurance companies insure $610 billion in mortgage debt, and there is no reason why private firms could not similarly insure bank deposits. American Share Insurance (ASI) provides $5.8 billion in insurance to credit union depositors, $250,000 per account, as a substitute for mandatory federal insurance of $100,000 from the government's National Credit Union Share Insurance Fund (NCUSIF), which mirrors the FDIC. ASI's subsidiary, Excess Share Insurance, provides credit unions with $772 million in private insurance coverage above the NCUSIF's $100,000 limit up to $350,000 per account. There is no need for a mandatory government-run system. Deposit insurance premiums would be more efficiently set by the market than by government, competition would drive down premiums, and there would be more product choice for consumers—insurance could cover a percentage of deposits or have limits below or above the FDIC's current $100,000. The current system is a government monopoly that forces deposit insurance upon consumers. Voluntary private deposit insurance would result in more consumer choice in a more efficient system.

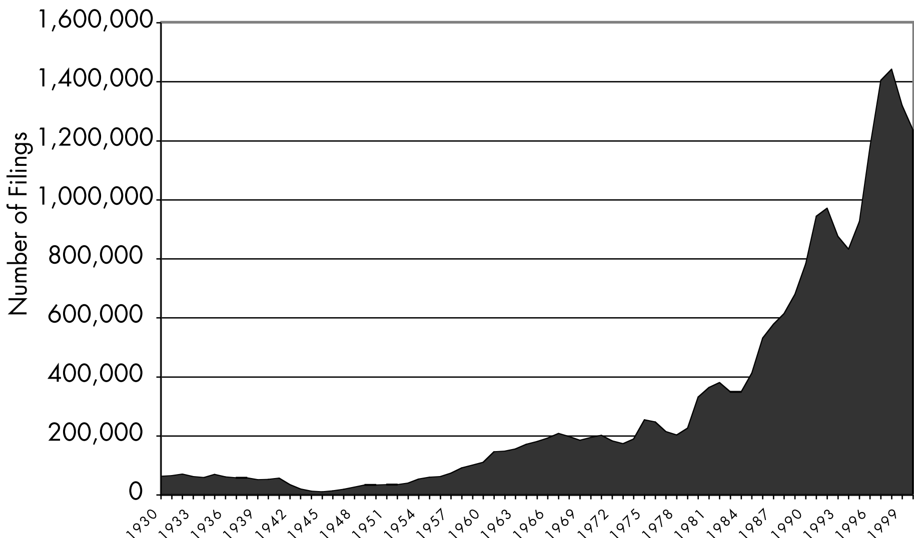
Bankruptcy Reform Is Long Overdue

The 106th Congress passed by overwhelming margins largely similar versions of the Bankruptcy Reform Act (H.R. 833, 313-108, and S. 625, 83-14). At end of session, final legislation was pending in the U.S. Senate under threat of a presidential veto.

Congress has been working toward reform since 1994 when it created the National Bankruptcy Review Commission. During the fall of 1997 bills were introduced that were direct predecessors of current legislation. During the last three years of delay in enacting legislation that had popular support, more than 4 million bankruptcies have occurred. As Figure 25.1 shows, more bankruptcies occurred during the last half of 2000 than during the entire decade of the Great Depression. During the decade of the 1990s, there was one bankruptcy filing for every nine households—a bit ironic during one of the longest recorded economic expansions.

Filing for bankruptcy makes financial sense because debtors, irrespective of income and ability to repay, can keep virtually all property and legally erase debts without payment once every six years. The financial windfall has attracted a growing number of debtors to substantially abuse the system.

Figure 25.1
Total Annual U.S. Bankruptcy Filings: 1930–2000



SOURCE: Administrative Office of U.S. Courts.

The 107th Congress has an opportunity to fix the system. Current law was shaped by a series of enactments during severe economic downturns, bestowing non-taxpayer-funded debtor relief by expropriating the contractual rights of creditors. Eligibility was widened, exempt property retained by debtors increased, each time expanding the access to, and the extent of, the court-ordered discharge of indebtedness. When the U.S. Constitution was framed, bankruptcy was a criminal offense. Defendant debtors were accused by plaintiff creditors of committing bankruptcy, which then meant incurring debts and absconding with property to avoid repayment while living recklessly and luxuriously off ill-gotten gains beyond the reach of creditors. Those convicted of bankruptcy were punishable by death in the English courts. Two centuries of debtor-friendly enactments ratcheted bankruptcy from its original intent to compel fraudulent debtors to equitably repay their debts into a pseudo–social welfare program for debtor relief. Modern bankruptcy law legalized what antecedent jurisprudence first sought to prevent, the nonpayment of debt.

The current system is quite generous. Debtors with incomes sufficient to service and repay debts can file for Chapter 7 liquidation once every six years. They keep exempt personal property, the rest of their current estate is theoretically liquidated and distributed among creditors pro rata, and the government absolves them of remaining unpaid debts, regardless of income. Exemptions in several states include real property limited only by acreage, which allows some people to keep luxurious mansions yet still be entitled to a discharge. University of Michigan professor Michelle White estimates that 15.4 percent of U.S. households could financially benefit from filing, and that statistic rises to 22.6 percent if debtors strategically convert their nonexempt assets to exempt property. Debtors in practice relinquish no property in 96 percent of Chapter 7 cases, and their creditors receive nothing. "Liquidation" in practice is merely a few pages of paperwork filed with the court to remove unwanted debts. The current statute is a get-out-of-debt-free card that encourages substantial abuse, planned bankruptcies, and the incurring of last-minute debts without intent to repay on the eve of a filing, often for spending sprees and luxury vacations.

The Bankruptcy Reform Act would introduce "needs-based bankruptcy," or means testing, to limit abuse and arrest the near-record filing rate. Under it, some debtors would become ineligible for a quick Chapter 7 discharge if they had sufficient income to repay a small portion of their debts. Excluded debtors could still file a Chapter 13 repayment plan, which

differs from Chapter 7 by using future disposable income to repay a portion of the debts over five years.

Means testing would not apply to debtors with incomes less than the median regional income, roughly $50,000 for a family of four. If projected disposable income, after deducting family living expenses, charitable contributions up to 15 percent of income, payments for priority obligations (e.g., child support), administrative expenses, and secured debt was sufficient to repay at least $6,000 of unsecured nonpriority debts under a hypothetical five-year Chapter 13 plan (H.R. 833), or at least $5,000 or 25 percent (S. 625), that would be grounds for dismissing a Chapter 7 case. This would encourage many debtors to either file Chapter 13 plans or not file for bankruptcy at all.

The legislation would also extend the minimum period between repeat bankruptcy discharges from six to eight years and cap homestead exemptions at $250,000, but the latter can be waived by state legislatures. Enabling people to discharge unpaid debts while keeping a quarter million dollars worth of real estate is still overly generous. The homestead exemption should be fully eliminated. Few consumers declaring bankruptcy (3 percent) relinquish any property for the benefit of creditors, and giving up a small amount of their estates to help satisfy their original obligations to creditors would be a significant incentive to not file. Congress should also replace the option states have to set personal property exemptions with a mandatory federal list. Generous state-set exemptions are intended primarily to limit nonbankruptcy judicial attachments under state law where the discharge is unavailable because of the U.S. Constitution's contract clause. Since a bankruptcy discharge is available under federal law, exemptions under federal law should be considerably less generous than those offered by the states. A large loophole that also should be closed is bankruptcy law's enforcement of nonalienation clauses, which allow multi-million-dollar pension plan assets to be fully sheltered from creditors. A portion of sizable retirement plan assets should be included in the estate, or alternatively the discharge limited in such cases.

The legislation allows debtors to contribute 15 percent of gross income to charities and religious organizations before making creditor payments under five-year Chapter 13 plans. This should be removed. Charitable donations are not a necessary living expense. The provision unfairly decreases creditors' already small recovery on contracted debts with favoritism to optional spending for deemed worthy causes financed by funds otherwise recoverable by creditors. This provision of the law is also subject

to abuse with the easy creation of tax-qualified charitable organizations for myriad causes. The House bill also allows bankrupts to spend $10,000 for their dependents' private school tuition as a deduction from disposable income before creditor payments, despite the availability of free public education. That provision should also be removed.

The median-income test exclusion plus excessive deductions, which lower available disposable income to repay the statutory minimum, limit the applicability of proposed means testing. Ernst & Young estimated that proposed means testing would exclude a mere 10 percent of current Chapter 7 filers and result in $4 billion more recovered by creditors annually. Law professors Marianne Culhane and Michaela White found that only 3.6 percent of debtors would be affected, with can-pay debtors partially repaying an additional $930 million of their debts. Means testing as currently worded would only marginally curb the bankruptcy rate. The median income test excludes 80 percent of filers, and, at most, half of those remaining have sufficient income after deductions to fractionally pay back debts under a Chapter 13 plan. The median income test should be removed from the legislation.

In addition, a large portion of the 1.3 million debtors who annually file are small debtors responding to legal advertising to delay eviction or discharge a few thousand dollars of debt for the cost of a few hundred in legal fees paid to bankruptcy attorneys. These petty filers clog the system. Most can afford the few hundred dollars a year to service their small debts. If they were excluded from the system, their property and income would remain well protected under state exemption and anti-garnishment laws. Congress should impose a debt minimum for bankruptcy as under prior statutes—say $5,000—to exclude petty filers.

Proposed reforms are not anti-debtor and pro-creditor as inferred by consumer advocates and bankruptcy attorneys dependent on the system. Providing an opportunity for debtors to legally discharge unpaid debts makes them higher credit risks, which results in higher interest rates and more stringent loan qualification requirements that exclude some people from obtaining credit. A study by WEFA estimated the financial costs of bankruptcy for 1997 at $44 billion, mostly discharged unsecured debt, which if passed on to households amounts to $400 per household, or 400 basis points in higher interest rates. Strengthening the statute by limiting relief would *benefit* debtors by lowering interest rates and improving credit availability.

Bankruptcy is the only social welfare program without means testing. Such testing is overdue to prevent abuse by can-pay debtors. The 107th

Congress has an opportunity to mend a broken bankruptcy law during the current economic prosperity and should do so by enacting a stronger Bankruptcy Reform Act that recognizes the sanctity of contracts and protects property rights.

Conclusion

The United States is the world's leading provider of financial services. Efficient financial contracting through private financial institutions allocates capital to its most productive uses. Distrust of markets resulting from the Great Depression led policymakers to enact a plethora of regulations, many of which are unneeded, harmful, or outdated. Regulation often impedes the efficiency of financial markets; forestalls innovation; imposes an unnecessary burden of paperwork; or, as in the case of bankruptcy, by rendering debt contracts unenforceable, precludes mutually beneficial exchange from occurring between lenders willing to extend credit and potential borrowers.

If the United States wants to retain its lead in providing financial services in the modern global economy, regulatory burdens must continue to be reduced. The Gramm-Leach-Bliley Act (1999) helped by breaking down the Depression-era walls separating commercial banking, investment banking, and other financial services. It will advance the modernization of the financial services industry and benefit consumers through increased competition, but more work needs to be done. The Community Reinvestment Act should be wholly repealed. Mandatory deposit insurance should end along with the government monopoly over it, and the FDIC should be privatized. Bankruptcy reform with stronger provisions should be enacted to limit abuse and lower the cost of consumer credit.

Financial services remain the most overregulated sector of the U.S. economy. The 107th Congress should continue to remove Depression-era laws in order to foster the efficient allocation of capital to, and by, financial institutions. That would augment economic growth, boost consumer choice, and strengthen U.S. global competitiveness.

Suggested Readings

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