The Heritage Foundation Backgrounder

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THE CASE FOR BANKING DEREGULATION

INTRODUCTION

If the manufacturing and retailing sectors can be described as the muscle and bone of the U.S. economic body, the financial intermediaries would certainly be the circulatory system. This country's 40,000 banks and savings and loan associations (S & Ls) play the crucial role of gathering the savings of individuals and businesses and using them to provide loans to other consumers and commercial enterprises. There is no other single industry as necessary to the nation's economic prosperity as the financial institutions. Should the U.S. automobile industry fail, widespread displacement would obviously result. But significant sectors of the economy would remain undisturbed and could continue to prosper. Should the financial intermediaries industry collapse, however, the resulting interruption in the flow of funds from net savers to net borrowers would bring the economy to a grinding halt. Almost every business enterprise in the country relies on credit for continued normal operation -- from financing inventories to expanding plants.

While complete catastrophe is very unlikely, American financial institutions are facing a crisis unprecendented since the early 1930s. Savings and loan associations have been particularly hard hit. Holding almost $700 billion in deposits, these institutions were expected to suffer collective losses of $5 billion in 1981 with 75 percent of the S & Ls and savings banks incurring operating losses during the year. Unless economic conditions change drastically or some action is taken soon, catastrophe on a lesser scale is sure to overtake the industry.

Many solutions have been offered. For some the answer seems to lie in regulating the currently unregulated competitors of banks and S & Ls -- particularly the money market mutual funds. Others advocate a bail out of the ailing savings and loan industry,

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

leaving basic industry structure unchanged and hoping the economic crisis is soon resolved.

A growing number of students of the problem are recognizing, however, that the regulatory structure surrounding the financial services industry is a part of the problem. As banker Lee Gunderson testified before the Senate Banking Committee:

> What is needed is an approach to legislation and regulation which recognizes the public interest is best served in a competitive marketplace, a marketplace where initiative, innovation, and performance are not restrained by discriminatory laws, complicated rules, and unequal regulatory treatment.[1]

In other words, rather than regulating the unregulated firms now offering financial services, the banks and S & Ls should be freed from at least part of the regulatory network currently binding them.

There are at least three broad areas where this sort of regulatory reform ought to be seriously considered. Restrictions on the pricing policies of depository institutions -- both those rates paid by banks and S & Ls to depositors and those charged for loans -- cause severe distortions and should be closely examined. The types of financial services banks and S & Ls may offer are also severely restricted and the liberalization of these powers is an area deserving of attention. Finally, geographic limitations have resulted in hardships, especially for consumers, and ought to be relaxed.

Legislation introduced by Senator Jake Garn (R-UT) represents a step in this direction. The step is one, however, that has met with and will continue to meet with opposition. Many banks and savings and loan associations currently enjoy a protected position. They are, understandably, reluctant to give up that advantage. Furthermore, the fears created by the 1930s' bank failures are deeply imbedded. But, the world is rapidly changing, and in order to offer the widest range of services to consumers, the regulatory barriers that financial institutions now face must be removed.

ROOTS OF THE PROBLEM

Underlying other causes of problems currently facing depository institutions are the volatility of the inflation rate and its absolute level. Both have increased dramatically in recent years. The 1965 inflation rate was 1.7 percent. In 1970, it had climbed to 5.9 percent. By the end of the decade, it had reached double digits -- 11.3 percent in 1979 and 12.4 percent in 1980. This ever-upward trend in the Consumer Price Index has created problems for financial institutions.

Banks and S & Ls historically have relied on the deposits of their customers to provide the raw material with which they make their principal product -- loans. Over the past few years, however, many depository institutions have found it increasingly difficult to attract and hold deposits. Existing legal restrictions on the amount of interest financial institutions may pay on savings accounts repeal the old adage, "A penny saved is a penny earned." Consumers gradually have come to realize the money left in savings accounts earning 5¼ to 5½ percent interest loses buying power in an economy suffering from inflation rates exceeding 5½ percent. They have reacted rationally, seeking investments yielding a larger return but providing the convenience of a passbook savings account.

As is the case when the market is allowed to work, this demand did not go unfilled for long. What banks and thrift institutions could not do because of legal restrictions, other firms did. The result was the emergence of the booming money market mutual funds. Total investment in these funds has grown from a mere $4 billion in 1978 to $185 billion at the end of 1981.[2] Growth during the past five years has been particularly rapid as more of the funds were offered to individual investors and start-up costs were lowered. In addition, Cash Management Accounts (CMAs), introduced by Merrill Lynch, provide checkwriting privileges tied to a brokerage margin account and a Visa credit card. Merrill Lynch has been adding 1,000 CMAs a day at $20,000 minimum. Prudential Insurance Company of America, recently merged with Bache Halsey Stuart Shields, Inc., is also preparing to offer a CMA account, as are American Express and several other financial firms.[3]

This phenomenal shift of funds away from traditional depository institutions is illustrated in the following graph. Many financial analysts are alarmed by these trends, and the American Bankers' Association points out that these trend lines are conservative estimates. Because of the regulatory framework within which they operate, however, banks and S & Ls have not been able to act to retain their deposits as they have been drained. To further complicate matters, depositors who have left funds in banks and S & Ls, for the most part, have placed them in accounts earning rates of interest above 5¼ to 5½ percent allowed on passbook savings. The six-month certificates of deposit (CDs), for example, have become increasingly popular, as have the All-Savers certificates and individual retirement accounts. Such a shift of deposits has increased the costs of funds for the depository institutions.

Another problem created for banks and S & Ls by high inflation rates is related to their role as lenders. The primary source of revenue for banks and S & Ls is the interest income from the loans they make. Banks generally make commercial loans while S & Ls and savings banks concentrate on mortgage lending.*

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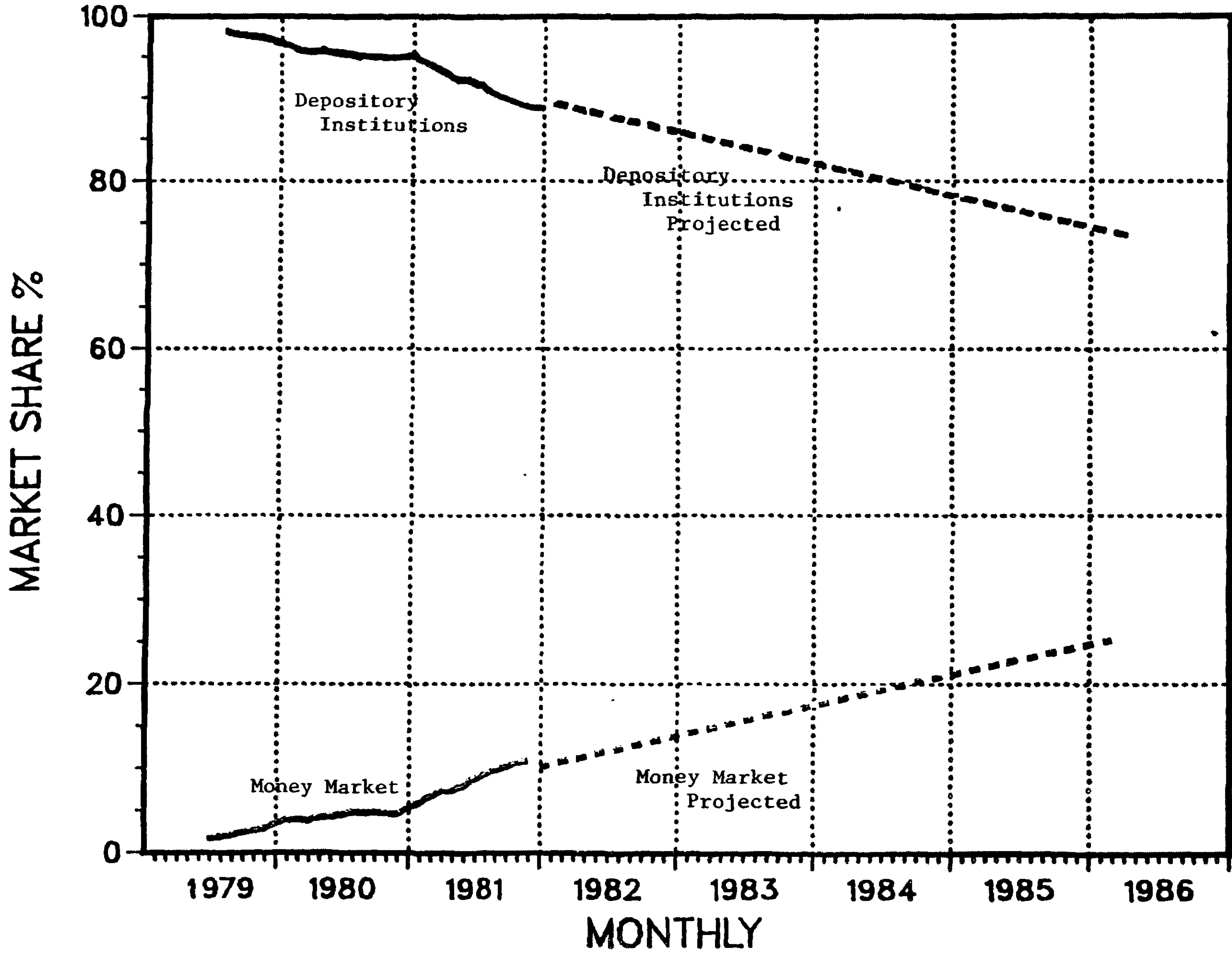
*Banks obviously also provide consumers loans, but commercial loans represent well over half of the loan portfolios of most banks.

ACTUAL AND PROJECTED MARKET SHARE OF INTEREST BEARING CONSUMER–TYPE ACCOUNTS AT ALL DEPOSITORY INSTITUTIONS AND MONEY MARKET FUNDS



NOTE:
PROJECTION BASED UPON HISTORICAL TREND.

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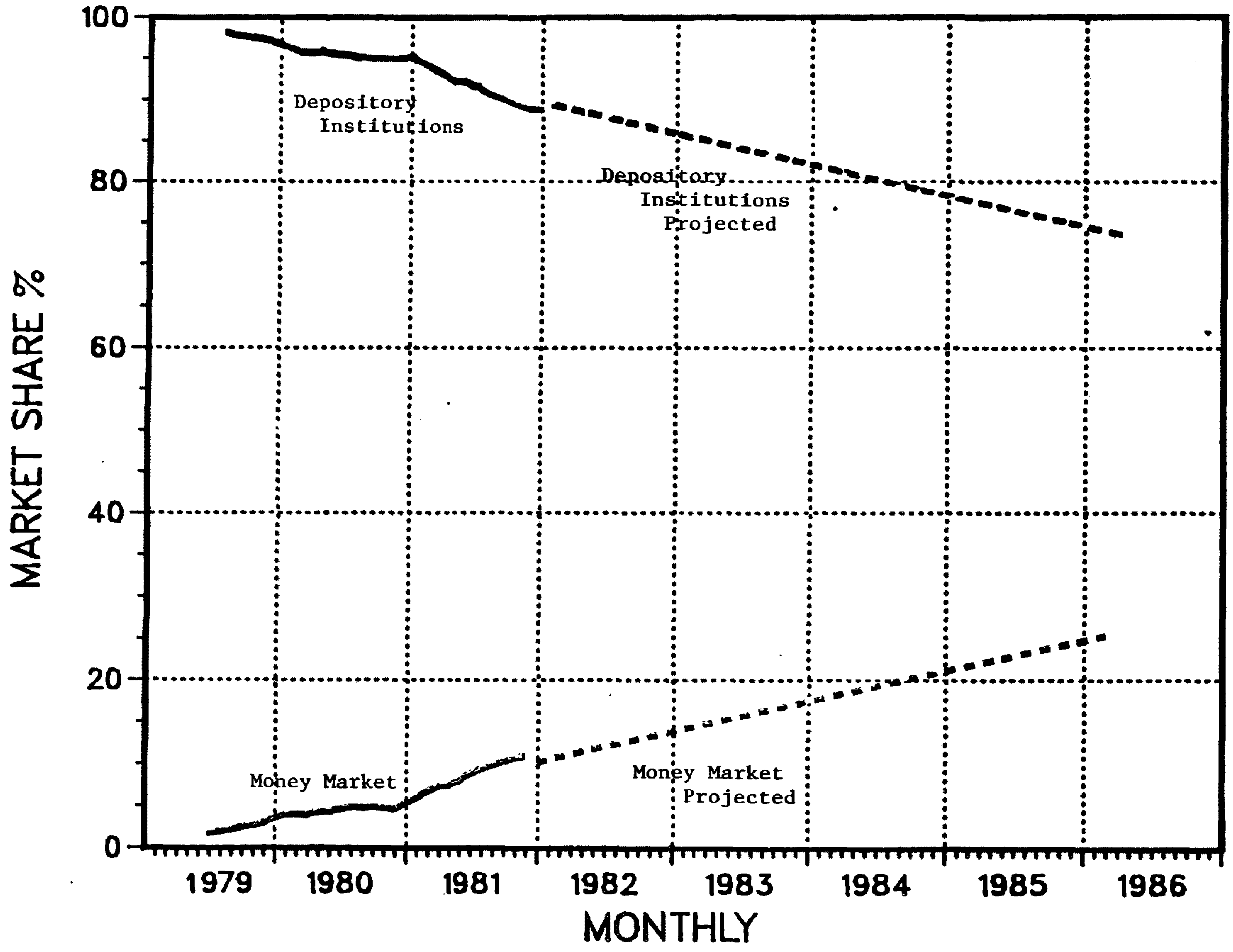

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The interest rates paid by borrowers are simply the prices of the loans. If the interest rate is below the average inflation rate over the life of the loan, the lending institution in effect loses money. This is because its costs -- salaries, electricity, building maintenance, and so forth -- rise at roughly the rate of inflation. To remain profitable, the prices (interest rates) charged by these financial institutions must rise too.

In some instances, however, banks and thrift institutions have been prevented by state usury laws from raising prices. In other cases, particularly for S & Ls concentrating in long-term mortgages, the major problem has been a lack of prescience. S & L executives were no better than anyone else at predicting in 1971, when inflation was 4.3 percent, that rates by the end of the decade would hit double digits. And yet, such exceptional foresight is exactly what would have been required to ensure an S & L's profitability today. Table I compares the average yields on mortgages with the inflation rates over recent years. It is apparent why many savings and loan associations are facing severe financial difficulties. This situation of rising costs of funds and low yielding portfolios was described recently in Harper's magazine by William Quirk as being "like buying apples at twelve cents and selling them for ten cents, a practice with a limited future."[4]

TABLE I

Year	Average Effective Yield on Mortgages Held by S & Ls [1]	Inflation Rate[2]
1975	7.10	9.1
1976	7.20	5.8
1977	7.35	6.5
1978	7.72	7.7
1979	8.21	11.3
1980	8.79	12.4

Sources: [1]Edward J. Kane, "S & Ls and Interest Rate Re-Regulation: The FSLIC as an Industry Bailout Program," unpublished paper, September 15, 1981, p. 8.
[2]Economic Report of the President, January 1981, p. 293.

Exacerbating their problems with inflation are the marketing restrictions imposed on the depository institutions. Not only can American Express, Merrill Lynch, Sears, and other new-style financial institutions offer accounts paying market rates of interest, many of which are also "checkable" (i.e., checks may be written against the account), they also face none of the geographic restrictions imposed on the depository institutions. For a population as mobile as that of the U.S., this is important.

Systems of electronic funds transfer, moving deposits instantaneously across the country, make possible the dispersion of automatic teller machines (ATMs) throughout the U.S. American Express, Visa International Inc., and Mastercard International Inc. are just a few firms which already take advantage of this new technology or plan to do so.[5] As use of ATMs spreads, individuals will be able to make deposits to or withdrawals from money market or other accounts from almost anywhere in the country. Similarly, the Sears U.S. Government Money Market Trust, recently introduced, has offices nationwide adding to "one-stop shopping." Banks and, to a lesser extent, S & Ls are prevented by law from offering these interstate services directly, however.

Instantaneous transfer of funds through air and telephone lines, moreover, means that an individual anywhere in the country can dial a toll-free number and conduct business with a large number of money market funds without leaving home. Warner Cable, a subsidiary of American Express, is currently experimenting in Ohio with home banking, bill-paying, and security-trading for subscribers via their televison sets. Thus, while less-regulated firms are seeking ways to take advantage of new technology, the extensively regulated banks and S & Ls are prevented from competing directly.

Traditional financial institutions, in short, are being squeezed between rising costs of funds and increased competition from unregulated firms. To make matters worse, a variety of firms are being allowed to offer services traditionally reserved to banks and S & Ls. The result: profit margins are shrinking and, in the case of most S & Ls, have disappeared completely. It is this situation which prompts the call for something to be done.

Before discussing what regulations ought to be removed or modified, however, it is instructive to examine why the depository institutions became so heavily regulated in the first place.

HISTORY

In examining the history of banking in the U.S., two themes emerge: 1) a deep-seated opposition to attempts to concentrate financial power, an attitude which has given the states a significant voice in the conduct of financial institutions; and 2) an attitude of protection toward existing financial institutions which grew from the widespread bank failures of the 1930s.

Decentralization

The history of U.S. banking, more than anything else, reflects the aversion of early Americans toward attempts to concentrate power in a central government. In fact, early efforts to establish a central banking authority, first in 1791 and then in 1816, while successful for a time, were eventually defeated. The power to grant bank charters was considered the sole prerogative of

state legislatures. These charters were obtained through special legislative acts, a method which, not surprisingly, was abused. Reacting to these abuses, Michigan in 1837 initiated a system of "free banking." Anyone meeting specific capital requirements could open a bank. New York passed a similar law the following year and soon most other states followed suit. As a result, banks were often established in a haphazard manner -- sometimes borrowing the cash necessary to meet capital requirements just before the bank examiners arrived.

Banks not only provided credit for a growing economy, but also, for better or worse, controlled the supply of currency. Each bank issued its own bank notes, or currency, based (supposedly) on the quantity of specie, i.e., gold or silver coins, held by the bank. During the period of free banking, many banks were opened in remote areas, making it difficult, if not impossible, for note holders to redeem bank notes for specie. This practice led to the term "wildcat banking" because many banks were located "where only the wildcats could find them."

The first successful attempt to give the federal government some voice in granting bank charters was during the Civil War. The 1864 National Banking Act, designed to help the federal government finance the war, empowered Congress to charter banks which were allowed to issue currency linked to the number of federal government bonds held as security. These bank notes were printed by the Treasury, thus providing the first national currency. The Office of the Comptroller of the Currency was created to administer federal banking laws.

Few banks sought national charters; state charters were easier to obtain and less restrictive. This prompted Congress in 1865 to impose a 10 percent tax on bank notes issued by state banks -- a move designed to tax state banks out of existence. This tactic failed because state bankers discovered they did not have to issue currency to operate profitably. Instead, they encouraged the use of checks drawn on demand deposits. The dual banking system, with both states and the federal government granting bank charters, was born and continues to the present.

Tying the supply of currency, as the National Banking Act did, to the number of government bonds held by banks led to problems. During the late 19th century, outstanding government debt was not continually increasing. This led to an unstable and inelastic money supply. Thus, need was perceived for a central bank with the flexibility and authority to deal with currency problems and to manage the banking system. The result was the Federal Reserve Act, passed in 1913. In typical American fashion, it was feared a single central bank would concentrate too much power in too few hands. Therefore, while overall policy was delegated to the Federal Reserve Board in Washington, the Federal Reserve Act created twelve Federal Reserve Banks distributed throughout the country to ensure consideration of regional problems.

Deep-seated resistance to banking monopoly also explains early attitudes toward branching. Most states originally did not allow state-chartered banks to establish branches. In fact, as late as 1910 only twelve states permitted branching. The silence of the 1964 National Banking Act on the subject was interpreted as a branching prohibition for all nationally-chartered banks (regardless of state law) until 1922. In that year, the Comptroller of the Currency ruled that any nationally-chartered bank could establish other offices to conduct routine business as long as those offices were not outside the city in which the head office was located. Congress formally endorsed this action with the McFadden Act of 1927 and extended the ruling to state banks which were members of the Federal Reserve System (FRS). Nonmember state banks remained subject to state laws.

During the 1930s, banks with branches enjoyed a lower failure rate than "unit" banks (those with only one office). As a result, the number of states allowing branching increased. In addition, the 1933 Banking Act (Glass-Steagall) removed McFadden requirements that national and state FRS member banks limit their branching to a single city, and made them subject to state branching laws.

As the economy recovered from the Depression, bankers again became interested in expansion. Bank holding companies became a popular means of growth, triggering attempts to restrict the holding companies. The Douglas Amendment to the Bank Holding Company Act of 1956 prohibited bank holding companies from acquiring banks across state lines unless expressly permitted by state law.

The history of U.S. banking, in sum, is a continuing struggle to ensure that financial assets and the power over them remain as dispersed as possible.

Protectionism

The result of free banking was the existence of over 30,000 banks by 1921. Failures were common, averaging 600 per year; yet overall the system worked fairly well as new banks quickly replaced failed ones. State or regional deposit insurance or insurance for all those in a particular occupation or with some similar bond protected most depositors from heavy losses. The early 1930s, however, saw unprecedented failures as panic and bank runs became all too common. By the end of 1933, only 15,000 banks remained. Many of the customers of the failed banks lost most, if not all, their deposits as the existing sources of deposit insurance found themselves unable to handle the massive failures. The high cost borne by depositors, the disruption of the money supply, and the number of sound banks that failed contributed to tremendous political pressure, clamoring that something be done about the banking industry. In response, the Banking Acts of 1933 and 1935 were passed, changing significantly the way in which banks and other other financial institutions do business.

The basic goal of the Banking Acts was to prevent widespread bank failures. It was widely assumed, for example, that bankers had contributed to their instability by attracting funds by paying ever higher rates of interest on deposits. To avoid this in the future, Congress prohibited interest on demand deposits and imposed ceilings on the interest paid to time and savings deposits. It was also argued that free banking created too much competition and an overabundance of "weak" banks. To remedy this, free banking was halted. Applicants for bank charters were now required to demonstrate "public need" for a new bank and to show that the profitable operation of a new bank would not cause undue harm to existing institutions. Criteria for establishing the "soundness" of prospective bankers were strengthened. And because bankers were accused of contributing to the over-valuation of shares in corporations in their role as investment financiers, the activities of commercial banking and investment banking were divorced.

Congress also sought to safeguard the customers of failed banks through creation in 1933 of the Federal Deposit Insurance Corporation. The FDIC was given authority to insure deposits and to supervise and examine banks to help preserve the health and stability of member institutions. Many observers saw the creation of the FDIC as an implicit commitment by the federal government to bail out the banking system in crisis. Most scholars agree that by increasing depositor confidence in the system, federal deposit insurance represents the most successful of the 1930s' devices to deter bank failures.

By emphasizing the protection of existing financial institutions, however, the banking reforms of the 1930s had the effect of creating a cartel. Branching restrictions allowed banks to define a specific territory for themselves and the 1930s' Banking Acts ensured that existing banks need not fear too much new competition.*

Past dedication to a fragmented financial system may have been justified. J. F. McGillicuddy, President of Manufacturers' Hanover Trust Company, writes:

> From a historical point of view, there is much to commend our banking system. The economic diversity between various regions of this continent of a country sometimes seems as great as the differences among the countries of Europe, language and long-ago wars aside.[6]

The local orientation of the many banks and S & Ls, therefore, probably made them more responsive to local needs and encouraged regional growth and development. The protectionist attitude of

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*For a more complete discussion of this point, see pages 12-15.

regulators and lawmakers can also be defended from a historical point of view. Events of the 1930s severely shook confidence in the banking system and there was need to restore faith in it. The new laws substantially strengthened banks' positions, reducing competition and often creating a monopoly in less-populated areas.

The wisdom of past legislators in solving problems of their day, however, must not deter today's Congressmen from seeking solutions to fit conditions which have changed dramatically in the past decade. The earlier desirability of protected, fragmented financial institutions should not impede a thorough examination of the regulatory system under which they continue to operate.[7]

Legislation of 1980

The history of banking regulation is primarily a story of congressional reaction to financial crisis. Typical is the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). The banking industry was being assaulted on many fronts. Interest rates were climbing with no end in sight. A rapidly growing number of savings and loans and mutual savings banks were on the verge of failure. Many of the new financial instruments authorized by the regulatory agencies were being challenged in the courts. The exit of banks from the Federal Reserve System was accelerating. Disintermediation, the movement of funds from traditional depository institutions into other forms of savings and investments, was becoming a severe problem.

Congress had to act. The DIDMCA included a broad range of reforms. One of the most significant will enhance competition through the gradual elimination of ceilings on interest payable on various deposits. Eliminating these ceilings was to occur in phases over six years. To accomplish this "orderly phase-out" of interest rate ceilings, the Depository Institutions Deregulation Committee (DIDC) was formed. The DIDC consists of five members: the chairmen of the Federal Reserve Board of Governors, the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, and the National Credit Union Association, as well as the Secretary of the Treasury. (The Comptroller of the Currency is a nonvoting member.)

In recent testimony before the Senate Banking Committee, a spokesman for the U.S. League of Savings Associations charged the DIDC with sending the thrifts to their ruin by lifting deposit rate ceilings too quickly. Several examples were cited. In September, for instance, the DIDC voted to raise limits on passbook savings accounts at banks and S & Ls by ½ percent, a change expected to cost the savings and loan industry $500 million with little prospect of attracting additional deposits or customers.[8] Before the rule could go into affect, however, the DIDC reversed itself under a storm of protests. On the other hand, the DIDC has stuck by its approval of ceiling-free 18-month accounts for IRA/Keogh customers beginning December 1, 1981. In addition, the

DIDC has refused to restore the housing differential* on money market certificate accounts -- one of the most popular savings categories. The absence of the differential has, according to the savings and loan industry, led to a shift of funds from S & Ls to commercial banks.

Many in the banking industry echo the S & Ls' general criticism of the DIDC, but rather than predicting ruin because of the fast pace of DIDC actions, they blame the snail-like rate of changes. These critics point out that in the 1½ years since its formation, there has been no change in ceilings on passbook accounts. Leaving the interest rate ceilings in place penalizes smaller savers who lack the resources or sophistication to invest in other financial instruments. In addition, ceilings on the interest that may be paid to depositors precludes banks and S & Ls from competing with money market mutual funds and other instruments for the savings of individuals. Thus, the drain of funds from depository institutions continues.

Interest rate ceilings for time deposits of more than one year will not be completely removed until August 1984, and the housing differential is retained on many of these deposits until August 1983. At least a schedule for their removal exists, however. Meanwhile, funds continue to flow to less regulated competitors.

The DIDMCA did more than create the Committee. The Act also authorized interest-bearing accounts against which checks may be drawn for all depository institutions. At banks, these take the form of automatic transfer accounts which allow automatic transfers between savings and checking accounts. Negotiable orders of withdrawal (or NOW accounts) were authorized for the depository institutions, and credit unions were granted legislative permission to offer share drafts. These instruments, while somewhat cumbersome, increase the range of services available to consumers. (However, some question why Congress did not achieve these reforms by simply removing the prohibition on interest-bearing demand deposits.)

In addition, the consumer lending powers of S & Ls were broadened and they were given permission to issue credit cards and offer trust services. Federally chartered mutual savings banks were granted authority to make business loans.

Addressing another problem, the DIDMCA pre-empted some state usury laws. State interest ceilings were removed for all mortgage loans and for business and agricultural loans of more than $25,000. This was subsequently lowered to $1,000 later in 1980. The Act

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*Commercial banks, by law, must pay ¼ percent less than S & Ls on many of their accounts. This differential is justified by the belief that its existence ensures a flow of funds to S & Ls and, thus, to the housing markets.

also addressed some complexities of the truth-in-lending laws, attempting to simplify the consumer disclosure and notification procedures. To minimize problems, the DIDMCA requires that federal financial regulatory agencies meet certain criteria before issuing new regulations. For example, the need for the new regulation must be clearly established; meaningful alternatives must have been considered, costs minimized, and conflicts and duplications avoided to the extent possible.

The "monetary control" part of the Act dealt with Federal Reserve complaints that the decreasing number of banks under its jurisdiction was frustrating attempts to control the money supply. Federal Reserve System reserve requirements, therefore, were imposed on the checkable accounts of all depository institutions. In return, the Federal Reserve must make certain services available to all depository institutions. In the past these services (access to the discount window* and check-clearing services, for example) were available only to FRS member banks, many at no additional charge. Under DIDMCA changes the Federal Reserve Banks must determine the cost of providing these services and establish fees accordingly.

All in all, the DIDMCA is a mixed bag of changes. Some aspects are definitely "deregulatory" -- the proposed interest ceiling phase-out and expanded power of thrifts, for example. Others increase the regulatory burden -- universal Federal Reserve reserve requirements, for example. Whatever its ultimate effects, the DIDMCA did not resolve the fundamental crisis. If anything, today's situation is worse than at the time of the Act.

Freedom to Fail

No solution of the crisis can avoid confronting the issue at the heart of the matter -- the need for a competitive market, one that provides consumers with the best selection of products and/or services at the lowest possible prices. For this only two conditions are necessary: freedom of entry and freedom of exit.

If new firms may enter at will, even a market with a single firm will approach the competitive ideal, serving consumers in the most efficient manner possible. If the "monopolist" behaves otherwise, the way is opened for another firm to enter, offering a better product and/or a better price. Consumers will be lured from the established firm. The incentives created by freedom of entry thus assure efficient behavior -- even by a monopolist.

The threat established by free entry loses credibility, however, without freedom of exit. A fear of financial losses and potential failure must exist to ensure that managers and owners

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*The "discount window" is the mechanism through which reserves are temporarily loaned to banks by the appropriate Federal Reserve Bank.

of firms adequately attend to consumer wishes. Yet if the government pledges to protect a particular firm or industry, the conditions evaporate for efficient economic behavior. To ensure that sheltered firms survive, the government almost always turns to restricted entry.

This is nowhere more apparent than in the banking and thrift industries. The general attitude of federal regulators was summed up by a former Comptroller of the Currency when he said, "We believe thoroughly in competition in the field of banking, and endeavor to provide it wherever possible without jeopardizing existing institutions"[9] (emphasis added). Similarly, on the state level, a banking supervisor remarked "Sound and ethical competition is a healthy thing but, of course, not to the extent of hazard to existing banking institutions"[10] (emphasis added).

Regrettably, the ideal of a competitive atmosphere and the reality of restricted entry are difficult to achieve simultaneously. If a new bank or S & L enters a market and provides better services than existing financial institutions, it may cause the failure of one or more of the existing institutions. Since this is considered unacceptable, the new bank or S & L generally is not allowed to enter -- even in cases where it is widely acknowledged that existing depository institutions are inefficiently run. As a result, many banks and S & Ls enjoy a monopoly-like (if not an actual monopoly) situation -- especially in less populated areas. They need not fear the entry of new competitors because the government has decided financial institutions should be protected from failure regardless of cost. Inferior services thus may be offered at inflated prices to the customers of these institutions because few incentives exist to encourage better behavior.

The costs imposed by a poorly run bank or thrift institution do not stop with the inadequately served customers of these institutions. They impose other substantial burdens on society.

The primary role of banks and other financial institutions is to distribute the available pool of loanable funds (created by the savings of individuals and businesses). Borrowers who are most productive, who best serve the consumer providing desired products or services, and who have the best future earnings prospects ought to receive the available loanable funds.* In addition, financial intermediaries separate those new ideas and ventures which represent real advances in service to the public from those which do not, providing start-up capital for the former group. When the inefficient management of a financial institution is protected from the discipline of competition,

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*This discussion assumes that borrowers are commercial enterprises. As noted earlier, consumer loans, with the exception of mortgages, represent much less than half of total borrowing.

however, uneconomic enterprises are encouraged while more productive firms may find themselves unable to obtain funds.

Admittedly, financial institutions differ from other businesses. The liabilities of depository institutions -- the checking and savings accounts placed there by customers -- make up over 80 percent of the U.S. money supply. The widespread failure of banks in the 1930s and the resulting instability in the flow of money and credit created real and severe economic problems. But with deposits insured by the federal government, customers need no longer fear for the safety of balances held by an insured depository institution. Widespread panic and resulting bank runs have been largely eliminated as a threat to sound banks. It is no longer necessary, therefore, to protect inefficient financial institutions to ensure the safety of sound banks and S & Ls or of deposits in general.

This is not to suggest that there is no role of the government in controlling entry into the financial institutions industry. Because of the extremely important role depository institutions play in providing the U.S. money supply and the flow of credit, minimum standards should be established for opening a bank or other depository institution. The adequacy of the new bank's capital structure and the general character of the management should be established as a necessary safeguard of the public's funds. Yet there is no need for government chartering agents to continue considering the future earnings prospects of the new bank or S & L. The prospective owners already have done this as a first step in applying for a charter. It also is not necessary to examine the convenience and needs of the community within which the new depository institution seeks to operate. This too is a fundamental component of the future earnings prospects. Finally, the continued existence of other banks or S & Ls within the area should be no factor at all in determining whether to approve the charter of a new institution. In short, the protection currently covering financial institutions must be removed; inefficient depository institutions must be allowed to fail.*

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*There is one legitimate concern connected with bank failure. Many banks maintain deposits, known as correspondent accounts, with other banks. In some cases, banks which are not members of the Federal Reserve System may keep a portion of their required reserves in this form. In addition, non-Federal Reserve System members may gain access to some Federal Reserve Bank services in this way. If a bank which holds correspondent accounts should fail, the smaller banks whose deposits are held by the failed bank could be seriously hurt -- through no fault of their own. This problem could easily be solved, however, by providing 100 percent deposit insurance for correspondent accounts rather than subjecting them to the $100,000 FDIC ceiling imposed on other accounts.

WHAT IS TO BE DONE?

Speaking to the Civic Federation in Chicago, Secretary of the Treasury Donald Regan listed four regulatory areas needing attention: 1) interest rate restrictions; 2) specialization of financial institutions; 3) the regulation of geographic markets; and 4) growth of the regulatory agencies. Some bankers have identified roughly the same four categories, calling them pricing, powers, place, and prudential restrictions. Other students of depository institutions have slightly different names, but most agree on the broad classifications.

Pricing

More than any other regulation, the pricing limitations account for the current crisis of depository institutions. Pricing restrictions are of two basic types: ceilings on interest rates paid on deposits and limits on the interest charged for loans.

As inflation rates have increased, consumers have found the 5¼ to 5½ percent paid on savings accounts at banks and S & Ls unacceptable. Depositors have been taking their money elsewhere. To understand the impact of these interest rate ceilings on depository institutions, think of savings accounts as the raw materials with which banks and S & Ls produce their primary service -- making loans. Limiting the rates that may be paid to depositors is analogous to restricting the price a steel manufacturer may pay for iron ore. Obviously, when market price increases -- as a result of inflation, for example -- the firm must be able to offer more for the ore. If it cannot, the ore seller will seek customers willing to pay the market price. This is exactly what is happening to banks and savings and loan associations. Deposits are moving to unregulated firms able to pay market rates of interest.

Of course, some deposits in banks and S & Ls pay interest at rates closer to the market return. To take advantage of these higher rates, however, the depositor is required by regulations to commit funds for a specified period of time. Those suddenly needing access to savings face a "substantial penalty for early withdrawal." Needless to say, the unregulated firms offering alternative financial instruments do not face these restrictions. Very often checks may be written on these accounts. Is it any wonder that money market mutual funds, combining near-market returns with accessibility, are attracting customers in droves?

The result has been a draining of traditional, low-cost loanable funds. Savings deposits in commercial banks fell from $191 billion in September 1980 to $158 billion in September 1981 -- an average decline of $2.75 billion monthly. The savings and loan associations have not fared much better. The deposits in S & L accounts paying 5½ percent fell by $15 billion during the fifteen months from July 1980 to September 1981.[11] Passbook

savings accounts that had made up 91 percent of all S & L deposits in 1966 and 43 percent as late as 1975, represented only 21 percent of S & L deposits by 1980.

Recognizing the problems caused by the limits on interest paid to deposits, Congress in 1980 enacted the six-year phase-out under DIDMCA. However, the Depository Institutions Deregulation Committee (DIDC) has yet to allow any increase in the rates paid on savings accounts. Citing objections by the savings and loan industry, the Committee voted 3 to 2 against raising rate ceilings in fall 1981.*

Representatives in the savings and loan industry claim that any increases in interest rate ceilings at this time will only make their situations worse. Unquestionably, as rates on deposits rise, the costs of banks and S & Ls will also rise in the beginning. As a practical matter, however, most depository institutions are obtaining much of their operating capital at rates above these ceilings, anyway. And, without an increase in the ceilings, the outflow of low-cost funds will remain unabated. Even members of the savings and loan industry are willing to admit as much. Richmond's Security Federal Savings and Loan Association President Edwin Brooks, testifying on behalf of the U.S. League of Savings Association, acknowledged,

> Savers routinely shift their funds from old low rate accounts and passbooks into the new, high-rate market related accounts....The balances in older certificate accounts will disappear completely in a short time.[12]

The percentage of funds obtained by financial institutions at above ceiling prices is thus constantly rising in any event, and higher rates would at least encourage the retention of consumer deposits.

Furthermore, interest rates are not expected to rise to market rates when the ceilings are removed. Savings accounts in banks and S & Ls provide more convenience, familiarity, and safety than most other financial instruments. In addition, an increase in interest paid on savings accounts should lead to funds flowing back to the depository institutions -- resulting in less dependence on the more expensive funds purchased at market rates. The costs of funds should thus eventually fall.

The movement of funds back to banks and S & Ls is desirable for other reasons. Most important, the pool of loanable funds available to banks and S & Ls will be enlarged. If encouraging investment in local communities and housing is to be public policy, a necessary first step is increasing the funds local

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*At the last minute, Secretary of the Treasury Donald Regan reversed an earlier vote that would have raised the rates by ½ percent.

financial institutions have to loan. If an overriding concern of the government is, as many claim it should be, protection of and service to consumers, the only equitable course of action is a speedy removal of restraints on interest paid to savings accounts.

While ceilings on interest rates paid on deposits are set at the federal level, limits on the prices lending institutions may charge for loans are set by state legislatures. These so-called usury laws generally are justified on the grounds that small borrowers must be protected from the "unbridled greed" of wealthy bankers. What happens, in fact, is that when interest rates in general rise above the ceiling, smaller borrowers without established credit ratings find themselves unable to obtain loans at all. While these small borrowers are "protected" from bankers, they are forced either to forgo loans or turn to the illicit loan-sharking industry, largely unencumbered by legal considerations.

Continued interest rate limits hurt only the small, unsophisticated saver or borrower. Those with more money can always find alternative investments with higher returns or alternative sources for loans.

Powers

Banks and savings and loan associations face strict legal limitations concerning the kinds of investments they make and the kinds of financial instruments they may offer. In the case of banks, most of these restrictions were established by the Glass-Steagall Act (also known as the 1933 Banking Act). They were prompted by arguments that the restraints would help preserve the safety and soundness of banks as well as reducing fraudulent stock practices. In the case of savings and loans, the restrictions were intended to help allocate credit to support the residential market. Congress in 1933 established the Federal Home Loan Bank System to charter federal savings and loan associations. Though not placed under the interest rate ceilings established for banks initially, the S & Ls were subjected to strict requirements mandating that the lion's share of their portfolios be held in the form of real estate mortgages.

Citing their current troubles, both the banking and the savings and loan industries are asking for new powers to permit increased portfolio flexibility. The banks blame their present difficulties in retaining deposits on their inability to offer the kinds of financial instruments available from their unregulated competitors. Savings and loan associations, meanwhile, claim that if they had not been forced to hold almost all their assets in long-term mortgages, they would not be suffering their current profit squeeze.

Members of the savings and loan industry further argue that, at least until now, S & L deregulation efforts have been unbalanced. Regulatory changes affecting the instruments that could be offered

consumers and the interest rates that could be paid on some deposits were begun as early as 1978. The first preemptions of state usury laws were not effective until March 1980, however, and a mortgage instrument allowing rate flexibility was not authorized until April 1981. Therefore, many individuals within the industry maintain that if interest rate ceilings on deposits are to be lifted, the savings and loan industry should be compensated with increased powers.

There is considerable theoretical justification for increasing the powers of banks and S & Ls. As Donald Regan remarked in a recent speech:

> The financial markets today change rapidly as one innovation follows another. Institutions have to be able to adjust, and the more specialized an institution, the less capable it is of adjusting.[13]

The financial needs of consumers and corporations are clearly changing. High inflation rates have made individuals and firms unwilling to hold substantial balances in idle accounts. On the other hand, these customers do not have time to deal with several different firms when taking care of their financial transactions. The accommodation of "one-stop shopping" represents a significant advantage. Therefore, competitive pressure is building as firms outside the regulatory mesh entangling banks and S & Ls cater to customer convenience by offering a wide range of financial services. Increased powers for banks and S & Ls should be considered as a means through which they may meet this new competition.

Banks are limited by legislation passed during the 1930s which allows them to underwrite municipal general obligation bonds, but not municipal revenue bonds.* At the time the law was written, revenue bonds were virtually unknown. Since 1932, however, revenue bonds have grown from 3 percent of the municipal market to 70 percent.[14] Most bankers favor changes in the law that would permit them to participate in the revenue bond market; they claim that bank competition in this area would reduce the costs of raising funds for state and local governments.

Banks also seek authority to issue a new type of instrument with enough rate flexibility to be competitive with money market mutual funds. Aside from deregulation of deposit rate ceilings, the most direct way to accomplish this is to allow banks and S & Ls to offer "comingled agency" or mutual funds accounts. After all, banks possess unsurpassed experience in managing short-term investments, experience on which many current mutual funds draw by using banks as investment advisors. Should bank customers be denied the direct benefits of this experience?

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*Municipal revenue bonds are paid through proceeds generated by the service they were used to build, e.g., sewage treatment, water systems, etc. General obligation bonds, on the other hand, are paid by general tax revenues.

While such funds would not immediately increase deposits available for housing, consumer, and commercial credit needs, they would offer banks and S & Ls an opportunity to retain customers who now are removing funds from traditional savings deposit accounts. Then, as deposit rate ceilings are relaxed and/or short-term interest rates fall, customers of the depository institution could more easily switch their funds back to insured deposits than if they were in money market accounts. Allowing banks and S & Ls to offer money market funds also keeps deposits under local management and reduces the flow of funds to the money centers. To ensure the widest use of these funds, banks and S & Ls could sell shares in any other bank- or S & L-sponsored mutual funds. This would permit small banks and S & Ls to offer a joint city- or region-wide mutual fund, or to sell shares of a larger institution's fund. The depository institutions would, of course, be subject to the jurisdiction of the SEC where their mutual funds were concerned.

The savings and loan associations are primarily interested in changes allowing them a wider range of assets for their portfolios. S & L leaders insist, however, that mortgage money would not disappear if S & Ls gain new powers. In the first place, current law requires that 82 percent of an S & L's portfolio be in mortgages if the institution is to qualify for certain tax advantages. More important, however, savings and loan expertise is primarily in providing mortgages. While seeking to reduce their interest rate risk exposure, most industry leaders willingly admit that S & Ls currently lack the requisite knowledge to enter the commercial loan market extensively.

The specific list of new powers sought by the thrifts and banks is fairly extensive. In general, the savings and loans want to acquire many of the most important powers now available to bankers. Examples: overdraft loan authority for demand accounts; authority for commercial, corporate, business and agricultural leasing; and opportunities for equipment leasing. Bankers similarly seek to gain major powers available to their nearest competitors -- the ability to issue mutual funds, underwrite revenue bonds, and expand real estate lending, among others.

Critics of these proposals complain that the changes would eradicate current distinctions between major types of financial institutions. It is very difficult, however, to continue to justify the sharp distinctions between classes of financial institutions -- particularly when they do not serve the consumer. Why should consumers be inconvenienced by having to deal with several different financial institutions simply as a matter of adherence to a principle established fifty years ago?

Other opponents argue that specialized financial institutions are necessary to ensure the continued provision of mortgage funds. To be sure, S & Ls have considerable expertise in providing mortgage money. Yet other conditions also ensure a supply of housing credit. The demand for mortgage money will continue with

or without specialized institutions to provide the funds. The reasons are that: 1) housing is a basic necessity; 2) because federal tax codes allow deductions for interest payments, there are tremendous incentives to own a home; and 3) the value of real estate as an appreciating investment can generally be expected. As long as the demand exists, there will be credit supplied. This should be particularly true now that new variable rate mortgage instruments are available, allowing financial institutions to share the risk of future interest rate increases with borrowers.

It has been argued that increased powers for S & Ls will not alleviate their current crisis. The problems of the industry, it is said, are the result of tying up their portfolios in long-term, low-rate assets -- not of having too few attractive alternatives for loans. No one is suggesting, however, that new powers will be a savings and loan industry cure-all. In fact, the thrifts have made little use of the new powers granted them by the 1980 Act. The trouble is that too much past legislation has dealt with financial institutions on a crisis-by-crisis basis. It is now time to take a long-term view and seek ways to give depository institutions the flexibility to deal with future crises rather than forcing them to bring problems to Congress.

Some managers of many smaller banks and S & Ls express fears that an expansion of powers will force their institutions into areas where their knowledge and expertise is limited. Yet there is no evidence to support this. As suggested with the mutual funds, the smaller banks and S & Ls could participate in services offered by the larger institutions, thus providing their customers with a wider range of options. Furthermore, it is obvious that financial institutions do not now all offer the same range of services -- even when that would be possible.

There is some concern among bankers that providing increased powers to the savings and loans will give them an unfair competitive advantage. S & Ls have less restrictive branching laws and capital requirements, for example, than banks. If the thrifts are given the wider range of powers which they seek, serious consideration must be given to removing some of these unfair advantages. The liberalization of bank branching restrictions would certainly be a step in this direction.

Place

Most businessmen recognized the U.S. was a national market, rather than a series of local markets, almost 100 years ago. This led to a substantial number of mergers between 1887 and 1904, consolidating many smaller firms that had been operating in limited geographic areas. Yet what has been accepted for every other industry is still not the norm for the depository institutions industry. Ritter and Silber, authors of a text on financial markets, noted:

> The small unit bank, like the Family Farm, is generally embraced as an integral part of the American Way of Life, regardless of whether or not it is economically viable so that it can stand on its own two feet in terms of costs and revenues. Conversely, bigness is typically equated with monopoly, especially where financial institutions are concerned.[15]

Objective conditions, however, contradict this view of banking. No other industry deals with a commodity so easily transported as does banking. Billions of dollars are transferred daily instantaneously all over the world with the sophisticated electronic systems. Automatic teller machines already provide 24-hour service to bank customers. Soon consumers will be able to bank by telephone and television through home computers. It is already possible to transfer funds between accounts or between institutions by merely picking up the telephone.

To further complicate matters, consider the mobility of the average American. He works, shops, and plays over wide geographic areas. It would seem the increasing ease with which money is moved would be a perfect complement to the mobility of the average consumer. The obvious conclusion is that funds from local banks should be accessible nationwide.

While the technology exists, the laws do not. Banks are restricted from branching across state lines and sometimes within the states themselves. Therefore, banks often cannot offer accessibility within a single metropolitan area -- if state or county lines are crossed. Because the courts have ruled that ATMs are technically branches, even though it is technologically feasible to develop a nationwide system of shared ATMs providing every individual with access to funds in his local bank regardless of where he happens to be, it is not legally permissible -- at least for banks. These restrictions, on the other hand, do not hamper the individual who qualifies for the gold American Express card with which cash is obtainable anytime, anywhere. Those with money in the Sears money market fund may soon have the same flexibility. Indeed, many other firms are planning to use this ability to transfer funds to provide nationwide -- maybe even worldwide -- access to deposits. Banks, however, are prevented by law from offering these services. This means that travelers away from home without the financial resources to invest in a nationwide money market fund better not need cash suddenly. The restrictions on banks exist because of the 200-year-old fear of "undue concentration of financial resources."

The U.S. supports almost 15,000 banks; Canada has eleven. It has been argued that if interstate geographic restrictions are lifted, a few large banks -- such as Bank of America, Chase Manhattan, Citibank -- would buy the others, leaving the U.S. with only a handful of large banks with tentacles reaching throughout the country. These banks, goes the argument, would then be able to decide which businesses grow and which fail, which regions thrive and which decline.

A move to interstate banking admittedly would result in some consolidation of the banking industry. Many banks would not survive in a truly competitive atmosphere. They now exist only because they are protected by restrictions keeping other banks out of their market. The price for this is paid by their customers who are certainly not as well served as those of banks facing more competition. Some small banks would undoubtedly be absorbed as the result of less restrictive branching laws. There is no reason to believe that well-run local and regional banks would not survive, however. Supporting this contention is strong evidence from the twenty-two states which currently have statewide branching. Without exception, every state allowing statewide branching has some banks that have chosen to open no branches and have survived. Table II, based on a sampling of these states, shows the number of banks in each of ten states and the percentage of those banks that do not operate branches. In California more than one-third of the banks have survived as unit banks despite potential competition from the nation's largest bank, Bank of America. In New York State, the evidence is even stronger. Facing potential competition from at least five of the nation's top ten banks, over 46 percent of New York banks continue to exist while operating one office.

TABLE II

State	Number of Commercial Banks	Percentage Without Branches
Alaska	12	8.33
California	257	33.46
Connecticut	65	16.92
Delaware	20	45.00
District of Columbia	17	23.53
Maryland	102	18.63
New York	302	46.36
North Carolina	83	18.07
South Dakota	155	67.10
Virginia	234	26.07

Source: The Report of the President, Geographic Restrictions on Commericial Banking in the United States, January 1981, p. 41.

Smaller local banks have substantial advantages over potential outside competitors. The most important is their knowledge of the local market -- the community's businesses and individuals. Furthermore, many customers prefer to deal with a locally-owned bank -- provided they are offered similar services as consumers dealing with branches of larger banks. Finally, at least some data suggest that economies of scale are unimportant for banks larger than $50 million.[16] This will be especially true if some sharing of services is allowed -- for example with mutual funds.

Still, there are advantages to interstate banking. In the first place, it would allow consumers access to their deposits over a wider geographic area -- allowing banks to compete more effectively with firms which offer services nationwide such as Merrill Lynch, Sears, and American Express. Most important, however, it would increase the degree of competition in the banking market. The mere threat of new competition is often enough to ensure that existing firms give customers the best service possible. Many small New York upstate banks, upon hearing that a New York City bank was about to open a local branch, suddenly have offered free checking, expanded overdraft privileges, or other new or expanded services.

Furthermore, the worst banking service often is found in towns too small to support more than a couple of banks. Frequently there is a shortage of local business demand for loans, even though there may be adequate deposit volume to support more banks. This would be a perfect situation in which to establish a branch of a larger bank. Branches are less costly to establish than a new bank. In addition, depositors would be better served because of the increased competition while the national economy would benefit from an improved flow of loanable funds to areas most in need of them. Should this small town suddenly experience increased economic growth, the branch banker is in an ideal position to facilitate the flow of funds into the community. In fact, evidence suggests that rather than using outlying branches to transfer funds to head offices in urban areas, banks are much more likely to transfer funds among rural offices according to loan demand.[17] And because Supreme Court decisions of the 1960s clearly subjected bank mergers to the Sherman and Clayton Antitrust Acts, the legal mechanism already exists to guard against "undue concentration of financial power."

Consideration of these arguments led the Department of the Treasury in a January 1981 Report of the President on geographic banking restrictions to conclude that:

> [L]iberalization [of these restrictions] (1) could improve competitive conditions in local markets and, subject to the establishment of appropriate controls, would not raise significantly the risk of undue concentration of power; (2) would increase the range of financial services available to local communities but would have little impact on credit availability; (3) does not pose a significant threat to the viability of the small bank as an institution; (4) would not have a material impact on the safety and stability of the banking system; and (5) need not threaten the vitality of the dual banking system.[18]

Other Problems

In addition to the regulations already cited, a number of others are particularly onerous. There is considerable dismay,

for example, with the "performance" regulations imposed on the lending institutions. These have nothing to do with the soundness of depository institutions, but are directed instead at affecting the way funds are invested and at "protecting" consumers. Such regulations began in 1968 with the Truth-in-Lending Act and include the Consumer Credit Protection Act, the Equal Credit Opportunity Act, the Equal Credit Opportunity Act Amendments, the Home Mortgage Disclosure Act, the Debt Collection Practices Act, and the Community Reinvestment Act, to name a few. These performance standards levy substantial reporting and regulatory costs that are, as are all costs, eventually passed on to consumers. To serve the consumer best, only one measure is required -- increased competition.

Another area of concern is the proliferation of regulatory agencies. No fewer than three federal groups exercise examination and supervision powers over some banks: the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve System. Savings and loans are in a slightly better position because the FSLIC is part of the Federal Home Loan Bank System. If S & Ls begin a more extensive use of their new powers, however, the Federal Home Loan Bank System and the banking regulators will oversee financial institutions with very similar functions. In addition, every state has its own group of examiners. When questions of mergers or new financial instruments or services arise, almost all the regulatory groups get involved. In many cases, decisions take months -- further reducing the ability of depository institutions to respond to competition from unregulated firms.

The power of the regulators has been expanding in recent years. This fuels fears that rather than accept a more flexible, less regulated atmosphere for depository institutions, regulators will insist on controlling the currently unregulated competitors of banks and S & Ls. While this might solve the problem for a time, when the situation changes, some less regulated firm (or firms) will find a way to respond. Then that firm (or firms) will be brought under the regulatory umbrella, and find itself unable to respond as conditions change. So another entrepreneur will fill the gap, and in turn be regulated. Reducing regulations thus offers the only course consistent with maximum service to the consumer.

The list could continue, but enough has been said to indicate the range of possibilities for regulatory change.

SUMMARY

Legislative solutions imposed in the past have been outdated by rapidly changing economic conditions. Continuing these restrictions merely perpetuates the costs imposed on consumers. To avoid this, a number of actions are possible.

First, pricing restrictions should be removed quickly. The ceilings on interest paid to depositors with funds in passbook savings accounts has hurt everyone -- the depositors with insufficient balances to move their funds to another instrument and the depository institutions watching accounts of large depositors flow to mutual fund and other financial instruments. In addition, usury laws dry up funds until they are unavailable at any price, at least to consumers without extremely good credit ratings.

Second, wider powers should be granted to banks and thrift institutions. Increasingly jealous of their time, most consumers are not going to travel all around town for financial services if they can find them in one location. Furthermore, under the careful eye of the SEC as well as the various banking and thrift regulators, past sins regarding stock market abuses are unlikely to reoccur.

Finally, the mobility of the American consumer must be recognized. If depository institutions are to properly serve their customers, they must be freed from regulations forbidding operations across state lines. Coupling a relaxation of interstate restrictions with a realization that inefficient banks _should_ be allowed to fail in the best interest of society would increase competition in many markets. Better service for consumers of financial services would surely follow.

Current Proposals

Several pending proposals typify the current debate on the deregulation of financial institutions.

The Garn bill. A major part of the bill drafted by Senator Jake Garn parallels legislation proposed by Richard Pratt, Chairman of the Federal Home Loan Bank Board. This legislation would give savings and loan associations authority to expand their commercial lending activities and to offer checkable accounts to commercial enterprises.* The thrifts would also receive permission to offer mutual funds and invest in corporate debt issues.

The Garn bill would also reduce restrictions applying to the asset powers of commercial banks. Example: The bill provides the authority for banks to underwrite municipal bonds and banks would be allowed to offer mutual funds.

In addition, the bill would expand the power of regulators to promote interstate and interindustry takeovers of failing banks and thrifts. These mergers could only be approved, however, if no other takeovers were feasible.

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*Under 1980 law, S & Ls can provide transactions accounts only to individuals.

Finally, Senator Garn's bill preempts all remaining state usury laws, with a three-year override provision. The legislation would also uphold due-on-sale clauses in mortgage contracts, thus overriding state preemptions of these clauses.

Senator Garn, who also happens to chair the Senate Banking Committee, seems committed to seeking significant deregulation of the financial services industry. He plans to hold exploratory hearings later this spring on the Glass-Steagall and McFadden restrictions on the banking industry. No legislation has as yet been proposed in these areas.

The "Regulators' Bill." The weakest proposal for regulatory reform comes from the House of Representatives. The "Regulators' Bill" passed there is an attempt to respond to a narrow definition of the current crisis without promoting long-run changes. The bill merely expands the authority of regulatory agencies to approve interstate and interindustry mergers -- as does the Garn bill. That is all. Chairman of the House Banking Committee Fernand St. Germain remains opposed to either interstate banking or the blurring of Glass-Steagall divisions.

Administration Proposals. The Reagan Administration supports recommendations that depository institutions be given the right to underwrite revenue bonds and offer money market mutual funds. The Administration favors giving the banks and thrift institutions the power to make direct investments in real estate equity. However, Donald Regan, the Administration's primary spokesman, has suggested that these new activities be carried on through affiliates of bank holding companies, though small banks of less the $100 million would be exempted from the requirement to establish subsidiaries.

While it favors granting wider powers to S & Ls, the Administration has stated that the S & Ls in exchange would have to give up their interest rate differential. (The housing differential, at any rate, is scheduled to be phased out by 1986.)

The Administration also supports efforts to allow securities firms to enter the banking business. These banking functions would be carried out by a subsidiary so that reserve and capital requirements would apply. Finally, the Administration endorses a federal preemption of state laws prohibiting due-on-sale mortgage clauses and the federal preemption of state usury laws.

CONCLUSION

Considerable support exists for fundamental changes in the regulatory structure surrounding depository institutions. There is little consensus, however, on the form of the changes. Powerful opposition in the House, moreover, comes from the Banking Committee Chairman. Hearings are being held in both chambers, though, and recognition seems to be growing that some sort of

regulatory reform is in the best interest of consumers as well as commercial enterprises. There is a growing cognizance that the depository institutions are being severely hampered in performing this function by 50-year-old laws.

The rigidty of the legal structure surrounding the depository institutions has finally made itself felt. The banks and S & Ls, in particular, are experiencing considerable problems because of their inability to respond to changing conditions. The average consumer and the economy in general are suffering. The same regulatory mesh making it difficult for the banks and S & Ls to respond to the changing economic scene has made it difficult for them to serve consumers adequately.

The regulatory network, justifiable when established, imposes an unnecessary burden in the 1980s. Federal deposit insurance protects depositors from substantial loss and significantly reduces the likelihood that public panic will pose a severe threat to sound banks. As a result, the protective attitude surrounding banks and S & Ls is no longer warranted. Not only would the system of financial institutions be stengthened in the long run and the efficiency with which loanable funds are moved be increased, but removing protective entry restrictions in banking would also mean that consumers of financial services would be better served.

Furthermore, the fear of concentrated financial power is unfounded. While some consolidation of depository institutions is to be expected if regulations are relaxed, that consolidation will result from the inability of a few inefficient, but sheltered institutions to adjust. Yet most cost savings can be achieved by relatively small institutions. This, plus the antitrust laws, will assure that the scenario of a few huge banks and S & Ls with branches nationwide will remain fantasy. Finally, there is no more fungible good than money; funds flow to those investments with the highest return. There is no reason to believe that would change with the slight concentration that would take place under more liberal branching laws.

The fears on which many of the existing regulations were predicated thus are no longer justifiable. And while the regulatory structure is no longer protecting consumers from real dangers, it is imposing substantial costs on bank and S & L customers. Substantial deregulation is the surest means of lowering these costs.

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8. Edwin B. Brooks, Statement on behalf of the United States League of Savings Associations before the Senate Banking, Housing and Urban Affairs Committee, October 21, 1981, p. 3.

9. A. Dale Tussing, "The Case for Bank Failures," Journal of Law and Economics, October 1967, p. 139.

10. Ibid.

11. Federal Reserve System's Statistical Release, H-6.

12. Edwin B. Brooks, Statement on behalf of the United States League of Savings Associations before the General Oversight and Renegotiation Subcommittee of the House Banking, Finance and Urban Affairs Committee, November 18, 1981, p. 4.

13. Donald T. Regan, Remarks before the Civic Federation, Chicago, Illinois, September 14, 1981, p. 8.

14. Llewellyn Jenkins, Testimony on behalf of the American Bankers Association before the Senate Banking, Housing and Urban Affairs Committee, October 20, 1981, p. 38.

15. Ritter and Silber, op. cit., p. 379.