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FINANCIAL SERVICES DEREGULATION

SUMMARY OF TASK FORCE HEARING

Dear Colleague,

June 15, 1988

The Task Force on Regulatory Reform recently held hearings on the subject of financial services deregulation. The goal of the hearings was to look at the changes occurring and needed in our financial institutions.

A wide range of interested parties commented on a number of important issues. What follows is a brief summary of the major highlights, along with discussion points raised by each witness. We hope you find this summary helpful as we prepare for major reforms in financial service delivery.

Respectfully yours,

Mickey

MICKEY EDWARDS
Chairman,
Republican Research
Committee

Dick

DICK ARMEY
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SUMMARY

While deregulation of banking and financial services continues to lag behind the pace of change in the market place, there are still many interested parties who would further slow the emerging changes. Committee action has occurred in both the House and Senate, but the particular interests of a number of affected parties are preventing the development of any sort of concensus in support of reform. Yet, some slow but important movement is occurring.

The recent shift of the National Association of Realtors to accept deregulation as long as clearly defined firewalls are in place, adds a another group to the supporters of deregulation, although the American Bankers Association and the nonbank Financial Services Council each have significant differences in their deregulatory plans. These three joined the Administration and some Congressional blocs in support of financial services deregulation.

Still allied against them are the Securities Industry, the smaller Independent Bankers Association of America, and the U.S. League of Savings Institutions. Little agreement exists between these two factions on the basic questions involved in deregulation. Depending on their orientation, deregulation is seen as either the solution or the problem.

But both sides do agree on some elements. They agree that federal regulators do not have enough resources to supervise a dynamic, changing financial services sector. They all also would prefer to see Congress address financial services reform legislatively, as opposed to regulatory decision-making by the Fed and other federal agencies. Almost all agree that the federal deposit insurance funds are in trouble and that changes in technology and the world market are changing banking. Whether that is for the better or worst depends on to whom you talk.

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Panel I -- THE FEDERAL RESERVE PERSPECTIVE

ROBERT HELLER, FEDERAL RESERVE GOVERNOR

GOALS:

-- Congress must restructure the national banking system for a world market, starting with investment banking, then interstate banking, and finally a total repeal of the Glass-Steagall bank laws.

SPECIFICS:

-- Congress must legislatively restructure the banking system to reestablish a level playing field currently imbalanced by technological and other changes in financial services.

-- Change will provide customers with increased competition, better flow of capital, lower costs, less concentration, and increased choice. Banks could offer new products in new areas and diversify their portfolios.

-- Increased bank risk and extension of the insurance safety net raises concerns, but risks can be controlled. Capital requirements should be raised, "firewalls" should be added to separate investment and banking, and disclosure requirements should be increased.

-- Timely approval of interstate banking would permit portfolio diversification, greater consumer choice, and more secure banks.

DISCUSSION POINTS:

-- FSLIC and FDIC could eventually be merged, but asset, health and functional problems would arise in the short-term. Ultimately, banks and thrifts should purchase each other and assist the new in the old field.

-- The financial pressure of the FSLIC bailout may create one financial insurance fund under the FDIC but time would be needed to integrate the different functions of banks and thrifts.

-- Interstate banking would minimize the damage to banks from commodity or regional downturns, like oil and the Southwest U.S.

-- The functional regulation approach is more desirable than the "go slow structure", although the need for cautious changes is recognized. "Go slow" describes how legislators are expanding financial services slowly with investment banking now, maybe insurance or real estate down the road. Functional regulation is a more open approach, permitting holding companies to get into any business but regulating each subsidiary according to its own rules -- a bank like a bank, a securities dealer as a securities dealer.

-- The ultimate goal is a broadly diversified company, with eased rules for ownership of a holding company along with functional regulation. Diversification would be a source of security, along with the specific resources of the bank holding company.

Panel II -- THE FEDERAL DEPOSIT INSURANCE PERSPECTIVE

WILLIAM ISAAC, FORMER CHAIRMAN OF THE FEDERAL DEPOSIT INSURANCE CORP.

GOALS:

-- Congress must repeal the artificial restraints on interstate banking.

-- The FSLIC needs personnel and financial assistance but a merger of FSLIC and FDIC would not provide sufficient resources.

-- The Federal Reserve should begin paying interest on sterile reserves maintained by banks and S&L's, amounting to about $2.5 billion a year. For a while, the new funds would go to the insurance funds, and later, to the banks and S&L's themselves.

-- If problems continue and the insurance funds become depleted, Congress may have to live up to the "full faith and credit" resolution it accepted a few years ago.

SPECIFICS:

-- Changes in financial services are driven by economics and technology, not design.

-- Between extremes of no government involvement and excessive government intrusion, government has a role to promote stability without stifling competition or innovation.

-- Change is an example of the marketplace rejecting unnecessary and inefficient restraints, like the old Regulation Q limit on interest payable on accounts.

-- The FDIC's hard-line approach of closing failed banks limited problems while the FSLIC's flexible approach and questionable merger policies led to high growth, high risk strategies that later failed.

-- Hot money chasing around globe looking for the best interest rates creates a need for strong supervision and discipline from both regulators and the market.

DISCUSSION POINTS:

-- The failure of Continental Illinois was not due to a subsidiary's securities activities.

-- Firewalls could be effective if there is separate capitalization, no intercompany funding, separate functional regulation, and restrictions on logo and personnel overlap.

-- The lack of manpower limits the help the FDIC could bring to the problems of liquidating failed banks.

-- Agreed with Rep. Bartlett (R-TX) that direct investment by savings and loans into commercial activities has created hazards and is a misuse of federally insured deposits.

Panel III -- THE BANKER, NON-BANKER, AND ENTERPRISE PERSPECTIVE

WILLIAM S. HARAF, AMERICAN ENTERPRISE INSTITUTE
FORMER ASSISTANT TO THE COUNCIL OF ECONOMIC ADVISERS

GOALS:

-- Congress must accept that technology has increased the importance of the international economy over the domestic. Unless Congress accepts these tremendous changes, archaic regulations will make America a second class financial power.

SPECIFICS:

-- The evolution of diverse, international, and competitive financial services is changing the face of domestic financial institutions and their products despite the barriers of the Glass-Steagall and Bank Holding Company Act.

-- Congress has not changed the laws and regulations to match the changes brought by technological innovation. World-class financial centers are evolving in Tokyo and London while the U.S. worries about turf, moratoriums and insurance fund bailouts.

-- Major U.S. corporations, like McDonald-Douglas, are opening international banks in London, not New York. Glass-Steagall is forcing the export of jobs in the financial services industries.

-- Long term impact of the loss of a dynamic financial sector will impair job creation, capital investment, and efficient capital markets. Technology is the new infrastructure and is particularly needed in financial services. But limits on the changes brought by technology in financial services is limiting the evolution of the new technological infrastructure.

-- Two-fold pressure on the system exist between those wishing to protect domestic financial service from competition and those wishing to be competitive in global financial services.

-- Competition and fewer barriers will not bankrupt the trust funds. Prohibitions on loans and transactions between insured affiliates will protect the trust funds.

-- Restrictions other than those on investments should ultimately be lifted and the market place should determine what activities can be performed within a single organization.

-- The stock market crash is not a reason to keep banks out of securities activity. The Brady Commission pointed out how a handful of mutual fund and securities firms were responsible for a large part of the selling activity during the crash. Promoting competition in securities activity would diffuse this concentration.

-- Deposit insurance is threatened not by the integration of banks with other firms but by the continued operation of troubled banks with little or no funds of their own at risk.

ED YINGLING, AMERICAN BANKERS ASSOCIATION.

GOALS:

-- The realities of the current financial service industry make terms like "bank" ill defined and misleading. Congress must update their regulations to reflect the reality of the market place.

SPECIFICS:

-- Congress has not realized the tremendous change in the financial services sector. Titles like "bank" no longer define an institution engaged in a constrained number of activities.

-- Securities and banking activities are already mixed as 8 of the top 10 securities firms now operate FDIC insured banks. Foreign banks are the major investors in 2 of these top ten securities firms.

-- U.S. banks abroad are permitted to fully participate in securities activity.

-- Finance companies like Household Finance Company are allowed to provide both loans and insurance, but bank holding company affiliates may not. GMAC lends for auto, provides mortgages, and can sell insurance.

-- Banks in 20 states are in insurance activities.

-- Realtors now feel that banking and real estate can mix, if adequate protection is given. Real estate dealers are now involved in the packaging of mortgages directly to the buyer and also are active in the secondary markets.

-- Only bank holding companies are excluded from offering a variety of services while multi-services are offered elsewhere.

-- Many of the bread and butter activities of banks have been lost to financial competitors like GMAC who has taken over the auto loan field.

SAM BAPTISTA, FINANCIAL SERVICE COUNCIL

GOALS:

-- Congress should fully open up the delivery of financial services to all holding companies that desire to participate, but with the appropriate safeguards. Specifically, the FSC supports Rep. Barnard's (D-GA) H.R. 3799, the Depository Institution Affiliation Act.

SPECIFICS:

-- The Financial Services Council represents a broad coalition of banks, non-banks, thrifts, finance companies, security firms and diversified companies.

-- Financial services reform appears to be too one-sided and will not truly open all financial activities to all financial actors.

-- Old compartmentalization rules on financial activities no longer reflect the reality of today's market place. The old lines of disinction are gone.

-- Diversification is an accepted hedge against risk in all areas but financial services.

-- The F.S.C. supports H.R. 3799, the Depository Institution Affiliation Act, introduced by Rep. Doug Barnard, which would provide a reciprocal financial structure and an equal regulatory footing.

-- H.R. 3799 permits any financial or non-financial business to own a bank or thrift, provided the company becomes a depository institution holding company and complies with the Act's regulatory and supervisory provisions. This is entirely optional.

-- Under H.R. 3799, the holding company is no longer limited in its other activities but would be subject to numerous supervisory and regulatory provisions, as well as other restrictions to insulate the depository institution from the non-insured affiliates.

DISCUSSION POINTS:

-- Rep. Bartlett suggested a functional regulatory scheme with firewalls and enforcement at the subsidiary level. This reflects the current situation of comingled ownership of financial institutions. Further, the reality of the financial world is far ahead of the pending legislation.

-- Ed Yingling of the ABA supported the functional regulatory arrangement but would not yet support the crossing of finance and commerce as the Financial Services Council suggests. The ABA understands the two way nature of banks going into securities, and vice versa. Banks feel securities firms already own banks.

-- Rep. Hiler (R-IN) pointed to the need for an overarching regulator, strong enough to secure public trust and prevent potential abuse but not too stifling to create an anemic financial system.

-- William Haraf of AEI responded that regulation at the subsidiary level rather than the holding company level would be adequate. While concerns exist over state chartered banks, the expectation is that the FDIC can monitor banks by looking at the transactions of the insured bank and the uninsured affiliate.

-- Ed Yingling of the ABA claimed the expiration of the moratorium would only continue the process of the last five years, and that the moratorium unfairly froze just one player in the penalty box while the rest played.

-- William Haraf added that Congressional inaction after the expiration of the moratorium would create a less rationalized system, create more court challenges, and impair the competitive balance.

-- Sam Baptista of FSC claimed the moratorium will likely be lifted but not the permanent closing of the non-bank loophole. Thus, only grandfathered non-banks can stay in banking activities. Further, the restrictive growth caps are unprecedented in this country's past.

-- Finally, Ed Yingling predicted that the Federal Reserve will continue to respond to applications for new products and services by banks, but slowly, installing firewalls where possible. This process would continue and, ultimately, marketplace realities will force an obsolete regulatory system to cave in.

Panel IV -- THE REALTORS, SECURITY DEALERS, AND ANALYST PERSPECTIVE

BERT ELY, PRESIDENT OF ELY AND COMPANY

GOALS:

-- Archaic regulation of banks and thrifts will further erode from technological change, international market pressures, and decreasing reliance on the power of markets to discipline imprudent banks and thrifts practices. Congress should reassess this balance by instituting real deposit insurance based on risk, less forbearance for insolvent banks, and greater reliance on market risk and failure to augment regulatory oversight.

SPECIFICS:

-- Two big issues are involved. First is the interrelated linkages between all financial services -- banking, securities, thrifts, insurance, real estate, and federal insurance. Financial and electronic technology is the fastest changing technology and thus permits financial services to evolve and enter each others once "sole" domain.

-- Second, federal deposit insurance is not really insurance, and it creates tremendous distortions and wastefulness. Unlike private insurance plans, federal insurers do not vary premiums according to levels of risk. This in turn perpetuates outmoded regulatory structures, such as the FDIC and FSLIC. We will continue to experience and pay for the inadequacy of our deposit insurance system.

-- Additionally, new complexities are being added by the persistent, mammoth trade deficit, which is producing a flood of foreign capital ownership into America. As foreign control over larger sections of American assets continues, the internationalization of our domestic financial structures will occur and diminish the power of regulators.

-- Further, these changes are creating breaking points in the regulatory structures which requires not more regulation but an acceptance of the limits of regulation. Most of the legislative and regulatory protections exist to protect industries, not consumers or depositors.

-- A number of myths still exist about the crisis of 1933. It did not justify federal deposit insurance. The majority of depositors did not lose confidence in most of the banking system. Further, federal deposit insurance didn't really install confidence in banks after 1934. Finally, banking is not so special that it cannot be integrated into the overall economy.

-- Firewalls are necessary for deregulation but not as a financial solution. There is no way to make secure firewalls, and those demanding firewalls are mostly those who fear and are opposed to change. Concentration is also a result of regulations and those benefiting from concentration oppose regulatory changes that diminish their benefit.

GIL THURM, NATIONAL ASSOCIATION OF REALTORS

GOALS:

-- The National Association of Realtors can accept opening of financial markets if real firewalls are created, and tie-ins, cross marketing, and other "financial arrangements" are prohibited.

SPECIFICS:

-- The National Association of Realtors recently changed their position to support expanded financial services, but only through separately capitalized and identified real estate subsidiaries. These subsidiaries should be established by legislation, not regulation, and a number of legislated safeguards should be included.

-- The realtors biggest concern is firewalls that prevent collusion. Examples were given of bankers using their lending power to force prospective borrowers to use their listings, sell their houses, or rent their properties when real estate agents already had deals arranged.

-- The realtors want legislative, not regulatory standards and safeguards to promote fair competition. Ease of entry into real estate licensing keeps real estate competitive but entry into banking is very restricted and limits competition. Their fear is tie-ins, cross marketing, and financing arrangements.

DON CRAWFORD, SECURITIES INDUSTRY ASSOCIATION

GOALS:

-- Congress could have avoided the problems of financial services deregulation by enforcing the Glass-Steagall provisions strictly. Removing the last remaining restriction -- the separation of commercial and investment banking -- will further damage our financial industries.

SPECIFICS:

-- The securities industry is the sacrificial lamb because it is the only industry that still operates within the existing Glass-Steagall rules.

-- The historical actions that both created and terminated securities affiliates by commercial banks must not be forgotten. The McFadden Act, which permitted banks to operate securities affiliates resulted in those affiliates taking over 80% of the underwriting business in 1933, up from 30% six years earlier. This act was repealed shortly after enactment because of a variety of abuses.

-- Many of the reasons for expanded bank powers into securities activities are somewhat confusing. If banks need profits from securities activities, then the crash of October 19 show this could be a dangerous reliance. If Congress wanted to preserve the wall between banking and securities, then the non-bank loopholes should have been closed and no grandfather clauses granted. If foreign banks getting into our securities business has caused the need for change, we could have prevented that. SIA feels banks have made more inroads into securities than security firms into banking.

-- Numerous non-bank products are currently offered through bank agencies, including mutual funds, investment trusts, commercial paper, mortgage-backed securities, municipal bonds, and private placement of corporate equity and debts.

-- Bank competition to lower costs hasn't worked in the brokerage business. Nor has there been lower cost in revenue bond underwriting. In Canada, all security firms save one were bought up by banks. In London, financial deregulation, called the Big Bang, lead to buyouts by commercial banks and insurance companies.

-- The securities industry has had little impact on the banking community's profitability. Securities dealing is very volatile, and banks can't handle that. If technology permitted the quick collapse on October 19, think what that could mean to banks. Most consumer groups oppose expanded activities of commercial banks.

-- Security dealers prefer separate securities affiliates to deal with the same sort of problems that the realtors mentioned. Real safeguards and prohibitions of service tie-ins are needed. In some instances, banks examine their customers checks and then request customers to use their banks services rather than some other outside firm. Further, many of these banks and non-banks have unregulated securities activities, promising huge returns on mutual funds. Use of the "FDIC" logo confuses the situation by hinting it may be an insured activity.

DISCUSSION POINTS:

-- Rep. Bill McCollum (R-FL) wanted to know about the paperwork burdens suffered by securities brokers, bankers and realtors. The securities representative responded that the SEC does not really overregulate. The SEC concentrates protecting investors and markets, not banks and deposits. The greater concern is the 50 state regulators, with regulations that preclude national, as well as international integration. The realtors work with the same number of state regulators, if not more, and desire that any new real estate firm must live within the same state regulations.

-- Rep. McCollum's major concern was that banks would bailout a floundering securities affiliate despite any of the firewalls or penalties. Mr. Crawford agreed and stated that the federally assisted Continental Illinois rescued its affiliate, First Option, despite regulatory barriers. Stiffer penalties, such as criminal penalties, might be necessary to prevent these actions.

-- In response to Rep. Dick Armey's (R-TX) question, Bert Ely stated that he felt the FSLIC bailout would fail soon, that market risk is vital to effective regulation, that risk based insurance premiums were necessary, that FSLIC/FDIC premiums were based on political rather than market forces, that forbearance policies have tremendously eroded the correcting force of market risk, that adverse risk taking will end only when bankers must pay the price of that excessive risk, and that the incentives in banking are out of whack as a result of reliance on central government planning instead of market mechanisms.

-- Rep. Armey noted that insurance plans based on spreading the risk will instead spread cancer if proper, market-based assessment of risk is avoided.

PANEL V -- THE THRIFTS, SMALL BANK AND FREE MARKET PERSPECTIVE

CATHERINE ENGLAND, CATO INSTITUTE

GOALS:

-- Bank failures are primarily due to government policy, not market forces. Market forces must resume primary regulation of banks through risk and closure.

SPECIFICS:

-- The current source of weakness is not market failure so much as government policy failure. Improper management of a faulty regulatory system has lead to destructive incentives.

-- Firewalls, increased capitalization, and geographic diversification are all needed but the closure policy of insolvent banks must be addressed.

-- Public perception of bankers has changed from the most conservative men in town to one bordering on a con artist. What has changed is the speed in which insolvent institutions are closed. Bankers need not fear closure for bad lending practices. Forbearance is all too common and sends the wrong message to the banking community.

-- Continued operation of insolvent banks or thrifts allows failed bank managers another chance but without any additional risk on themselves. All the risk now goes to taxpayers and other depository institutions. It is as if we were willing to finance a gambler who had lost all his money.

-- Besides increasing losses for deposit insurance agencies and promoting continued risky operations, forbearance unfairly damages prudently managed banks and thrifts.

-- Forbearance requires intensive surveillance by bank regulators which they are unable to provide. They need help and only the market forces can provide that oversight. But that requires limits on buffering banks from market discipline.

-- High interest rates relative to other banks probably indicate a troubled bank. Federal examination should occur more regularly. Loss of large deposits should also trigger closer scrutiny.

-- Ultimately, the threat of losses for uninsured creditors is the only way to force solvent lending practices. In response to the blanket bailout of Continental Illinois, the Federal Reserve and the FDIC should come up with a clear, stated policy that puts certain creditors at loss in future failures.

-- Instead of funds, loans backed by the guaranteed deposits might be provided to permit a systematic liquidation of a failed bank.

-- CATO summarized its three points as 1) prompt closing minimizes long-term losses; 2) bank managers will be more cautious if subject to prompt removal in cases of insolvency; 3) regulators cannot police banks without help of uninsured depositors and creditors.

KENNETH GUENTHER, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

GOALS:

-- Competition will not be enhanced by erasing lines between investment banking and commercial banking. Fewer entities will lead to less competition. Too many believe firewalls may work without knowing they will certainly work.

-- Further state experimentation is preferable to any federal legislation that might be rushed through this year.

SPECIFICS:

-- Deregulation has troubled, weakened and destabilized some financial institutions, which could now threaten the deposit insurance funds.

-- Repeal of Regulation Q governing interest rates was signed into law by President Carter, but has undermined the deposit insurance system of the 1930's.

-- Diversification, not specialization, is causing the problems with Glass-Steagall. Checking accounts for thrifts did not solve their problems. Congress has permitted diversified non-bank banks to exist over the objections of Paul Volcker and other experts.

-- Walter Wriston's statement that "banks would never walk away from a failing subsidiary if their own name was on the door" is an ominous sign. Also, Mr. Guenther added Paul Volcker's statement that insulation between securities affiliates and banks are far from complete and attempts to complete separation would be very difficult.

-- The Administration's belief in terminating geographic restrictions is based on faith, not fact. Most states are breaking down the walls, not the federal government.

-- The securities market is too volatile for banks, and stock crashes should not be allowed to destroy banking and thrifts.

-- The next FSLIC bailout will likely involve billions of taxpayer dollars, and in that sort of crisis, Congress will probably break the political stalemate and pass comprehensive banking reform.

PHIL GASTEYER, U.S. LEAGUE OF SAVINGS INSTITUTIONS

GOALS:

-- The question should be not how much more deregulation, but how to restructure our present system to make sure what we already have is strong and secure.

SPECIFICS:

-- Savings and loans can already acquire securities affiliates with strict firewalls and prohibited transactions. Thus, the League has no claim in the current banking/securities affiliation battle.

-- Because of strict firewalls, some financial firms avoid S&L charters and opt for more flexible non-bank classification.

-- As long as insurance, regulation and examination are needed, the essence of the Glass-Steagall structure exist. Increased regulation is just the flip side of the removal of ceilings on interest rates.

-- The public demands maintenance of the $100,000 deposit insurance per account. "Systematic risk" of banking makes market discipline inadequate. Most bills don't eliminate Glass-Steagall, only replace it or overhaul it with new restrictions and requirements.

-- The large decline in the number of bank examiners during 1983-1985 harmed the system, led to more risk, and forced the FSLIC bailout of 1987.

-- Risk-based premiums are needed to prevent banking abuse. Thrifts now have risk based deposit premiums. But this raises the problem of who determines risk.

-- The FDIC and FSLIC should not be merged. The funds must operate to protect different situations and that requires some unique characteristics. While other institutions can provide mortgage loans, the long term stability of credit is at stake.

-- Finally, the recent FSLIC bailout is not a good model for future replenishments. The League hopes the risk based FSLIC bailout will stem any future assistance. The FSLIC fund presently suffers from a federal supervisory failure and the interest rate problems of the 1970's.

-- The League hopes that bailouts of FDIC, FCUDC, PBGC, and other securities protection funds will not involve taxpayer funds. The farm credit corporation was just saved with taxpayers dollars.

DISCUSSION POINTS:

-- Representative Armey asked that if the FDIC logo breeds a false sense of security, which makes bailouts more common, is there some other way to dissipate risk without promoting imprudence? Phil Gasteyer responded that federal insurance is the only mousetrap available. Kenneth Guenther said that if not for the $100,000 insurance on accounts, the October 19th collapse would have lead to bank runs. He further added that economists from Galbraith to Friedman agree that federal deposit insurance has worked well. Catherine England stated that we could begin to wean ourselves from the $100,000 insurance cap by lowering the cap and permitting greater regulatory freedom.

-- Representative Armey further inquired if the self-regulating phenomenon of the markets would help bankers learn to say "no" to potentially bad loans. Kenneth Guenther noted that the government says no to small banks when they need help, but big banks like Citicorp have their problems personally addressed by Secretary James Baker. Phil Gasteyer noted that many problems in Texas thrifts are due to state bank changes that did not fully address the downside risk of overextended credit for commercial activities.