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MEMORANDUM TO WORKING GROUP ON DEREGULATION

FROM: Nancy Mitchell

DATE: 7/11/91

SUBJECT: Deregulation paper: Financial Services chapter

Attached is the revised edition of the financial services chapter of the deregulation paper. Significant changes have been made based on the comments received by the Council.

A staff level working group has been scheduled from 1:00 to 3:00 on Tuesday, July 16 in room 476 of the OEOB. As with other chapters, staff wishing to make changes should come prepared with actual substitute language.

If you have any questions please contact me at 456-6222.
Thank you for your cooperation.

Chapter 7: The Dangers of Incomplete Deregulation

The financial services industry in the United States has been closely regulated from its inception. The services which it provides uniquely bridge market imperfections, improving the efficiency of the macroeconomy. However, technology and financial innovation are eroding the conditions which favored the initial structure of banks. Although some barriers to competition among and within segments of the financial services industry have been removed, in accordance with the changing nature of the industry, remaining restrictions on product offerings, geographic markets, and corporate affiliations are no longer appropriate. Their continued presence thwarts innovation, adds needless costs to American consumers and businesses, and harms U.S. international competitiveness. Poorly conceived and inaccurately priced federal deposit insurance diminishes market discipline, encourages excessive risk-taking, and creates large liabilities for American taxpayers. The banking industry has been weakened by these changes, problems, and the fragmented regulatory system has not been successful in stemming the decline.

A comprehensive reform of the nature of government intervention into the industry is needed to ensure a safer, more competitive banking system. This reform must take into account the changes in the market for financial services and the underlying forces which drive them. We need to commit to a financial system that provides for the maximum degree of free-market discipline for our financial institutions, consistent with a stable financial environment.¹

The Policy Interest in Regulating Financial Services

The financial services industry arose in response to the needs of a newly industrialized country. Financial institutions provide:

(1) portfolio management services whereby individuals can acquire fractions of income flows from the institution's investment in large projects. Such projects are typically indivisible, not available as an investment choice by individuals.

(2) risk and maturity intermediation services, whereby the risky income from its asset holdings is distributed by the financial institution among its various classes of debt and equity holders. Individuals can thus select the financial claim which offers the risk profile and maturity most useful to their own needs.

(3) payments services, whereby transactions necessary to

the economy are carried out through the process of clearing checks (which represent claims on deposits payable in full upon demand).

As an intrinsic part of (1) and (2) the institution assesses the credit risk and monitors the payment performance of its assets, which the individual, because he does not possess sufficient information, could not do.²

While banks perform all three services, it is argued that the primary services which make them "special" is their issuance of demand deposits, which link them with the creation and control of money as well as with the payments mechanism.³ The link to monetary control arises through the fractional reserve requirement; thus this unique service performed by banks is mandated by the current monetary system.⁴ In addition, banks typically lend to borrowers whose credit worthiness cannot otherwise be easily or cheaply evaluated. To the extent that the credit intermediation function can only be performed by banks, this third service also qualifies them as "special".⁵

The benefits of these services to the economy and the problems associated with cumulative bank failures provide the rationale for public intervention into the industry. In the language of macroeconomics, the stable provision of these services--banking system stability--is a "public good". Government intervention to provide such a good is appropriate and enhances economic efficiency (assuming that the cost of the intervention does not outweigh the gains). The regulation of banks has focused upon the link between their individual failures and systemwide banking instability which disrupts the macroeconomy. The link is two-fold: (1) common exogenous factors may cause banks to sustain losses often enough to cause banking system instability, and (2) the failure of one bank may increase the probability of other failures through the mechanism of bank runs.⁶ The policy response has been to break this link through the imposition of controls over risk taking by banks, which helps reduce individual failures, and the use of federal deposit insurance, which ensures system stability in the face of individual failures.⁷

As the market imperfections are modified by changes in markets and/or technology, the services needed to bridge them are changed as a consequence. This inevitably changes the financial intermediaries themselves and the nature of government intervention must accordingly be changed. The past several decades have witnessed just such changes.

History

Early Banking Instability: Early bank runs were usually flights to currency, as depositors lost confidence in the ability of the

bank to redeem deposits. Because they caused severe contractions in the money supply, such runs led to significant financial instability.⁸

The creation of the Federal Reserve System in 1913 attempted to deal with the instability in two principal ways--requiring banks to hold deposits held at the Federal Reserve Banks as reserves against deposits, and enabling the Federal Reserve to provide temporary liquidity to troubled banks in the form of loans so that they would not have to call in otherwise good assets.⁹

Banking Failures and the Depression: Prior to the economy's collapse, the banking industry was characterized by the presence of thousands of "unit" banks, forbidden by law from setting up branches. In 1921, the U.S. had 30,546 banks, 98.2 percent of which were unit banks, with a median asset size of \$335,000. Because of their relatively small size and geographically concentrated customer base, these banks were very vulnerable to changing conditions. Indeed, even through the prosperous 1920s, bank failures were common. Between 1921 and 1929, 5,712 banks failed. Most of the failed banks were very small with average deposits of \$284 thousand (approximately \$2.1 million in current dollars), had no more than 3 employees, and were located in small rural communities.¹⁰ Bank failures rose dramatically as the economy entered the depression. Between November 1930 and the 1933 bank holiday, 9,096 banks failed with depositor losses of \$2.5 billion.¹¹

Compartmentalization (1933-1973): The banking instability of the Pre-Depression era and the collapse of the crisis years of the 1930s gave rise to a long list of reforms designed to prevent another recurrence. Responding to the public misconceptions that blamed the Great Depression upon "excessive competition" and "speculation" among financial services firms, Congress tried to correct these "market failures" through compartmentalization of the financial services industry. The financial services market was divided among several specialized noncompeting institutions. Congress confined commercial banks and thrifts to activities that were perceived at the time as relatively risk free. Specifically, banks were to extend commercial loans and accept both checkable and non-checkable deposits, while thrifts were to extend long term, fixed-rate home mortgage loans and accept only non-checkable deposits.¹²

Rather than view bank failures as a symptom of a weak economy, however, many politicians saw banks themselves as the cause of the Depression, particularly insofar as banks at the time were not prohibited from the securities business. Congress felt that commercial banks involved in securities activities tended to channel bank funds into "speculative" investments to the detriment of overall economic growth and stability. In

addition, it concluded that the separation of commercial and investment banking was necessary to restore public confidence in the banking system. Finally, questionable activities engaged in by banks and their securities affiliates raised concerns. Rather than attempt to restrict or prohibit these practices, Congress passed the Banking Act of 1933 (the Glass-Steagall Act) which separated commercial banking from investment banking altogether.

There is little evidence to support Congressional claims (most notably those of Senator Carter Glass) that the securities activities of commercial banks and their affiliates contributed to the large number of bank failures during 1930-1933. Despite lengthy and exhaustive investigations, Glass was only able to uncover one out of the 9,096 banks that failed during 1930-33 whose failure was attributed to the activities of its securities affiliate.¹³ Indeed, empirical evidence exists which suggests that securities activities actually contributed to banking stability. One study, done in 1986, concluded that the presence of a securities affiliate tended to reduce the likelihood of a bank failure:

While 26.3 percent of all national banks failed in this period, only 6.5 percent of the 62 banks which had affiliates in 1929 and 7.6 percent of the 145 banks which conducted large operations through their bond departments closed their doors.¹⁴

To a large extent the 1933 Banking Act reflected the belief that the quality and quantity of bank credit could be controlled if banks restricted their activities to short-term loans for business purposes, funding them by accepting the deposits of the public.¹⁵

At the same time, Congress guaranteed the profitability of all but the most inefficient banks and thrift through entry restrictions and price controls. For a thirty year period, the federal and state governments virtually ceased to grant new bank and thrift charters. Many liberalized branching laws were enacted during the 1929-39 period in recognition of the weakness of unit banking in withstanding the stresses of the Depression.¹⁶ However, various federal and state restrictions on acquisitions and branching limited the entry of established banks and thrift into new geographic markets.¹⁷ Banks were forbidden to pay interest on checking deposits, and ceilings were established for the interest rates on non-checking bank and thrift deposits.

Finally, the federal deposit insurance system was created; a comprehensive program to support thrift institutions was put into place, and an elaborate structure of federal agencies was given responsibility for supervising insured institutions.¹⁸ For the insurance protection, banks and thrifts have paid a flat rate premium based on their total domestic deposits. Although the

amount of coverage was legally limited,¹⁹ the way in which the insurance funds have handled bank failures has had an important impact on their overall exposure to losses. (Since 1955 the FDIC has based its resolutions of failures of banks which are not deemed essential to their communities on a cost "test". This test consists of a comparison between simple payoffs of insured depositors and arranging transactions in which healthy institutions assumed the deposit liabilities of the failed institution, effectively extending the insurance protection to all depositors of the failed institution. Over the past twenty years, only about 25 percent of bank failures have been resolved through payoffs of insured depositors.²⁰

Congress hoped that federal deposit insurance would both protect small unsophisticated depositors and prevent the unwanted macro-economic effects of a system-wide bank run.²¹ Federal deposit insurance has indeed ensured banking stability because it breaks the link between individual bank failures and system instability, by allowing depositors to substitute the credit worthiness of the U.S. government for the credit-worthiness of their bank or thrift. As long as depositors retain confidence in the ability of the U.S. government to meet its obligations, federal deposit insurance prevents bank runs. Although system-wide bank runs are no longer a problem,²² the federal deposit insurance program has created other, and possibly more costly, problems that only now are becoming apparent.²³

The nature of the problems posed by deposit insurance was recognized at the time. Opponents argued that deposit insurance would remove penalties for bad management, thus subsidizing poorly run banks; the cost of the insurance might accordingly be exorbitant and require the use of tax revenues.²⁴ Congress envisioned that the risk to the insurance funds would be controlled through the combination of the market segmentation and command and control regulation²⁵ rather than risk-based pricing of deposit insurance premiums. The efficacy of the compartmentalized system of banking laws and regulation depends upon the stability of the economic environment surrounding it, in particular: (1) a slow rate of technological change in the regulated industry; (2) homogeneity among firms within the industry; and (3) an ability to identify and control potential competitors outside of the industry who can provide the services needed by the market. Such stability assures the continuity of the bank's "franchise," the unique market services it provides. By contrast, a changing technology and economic environment erodes the market niches which the existing financial institutions were structured to serve, and/or provide for new ways in which to serve continued needs. This changes the nature of the market for services, allowing for structural changes in existing industry members, and giving outside competitors the opportunity to enter. These changes, in turn, force changes in the nature of government intervention. The history of the

financial services industry subsequent to the Depression is a testament to such changes.

The Post-Depression Period: From 1933 to 1973, the regulatory segmentation of the financial services industry held together fairly well despite some fraying at its edges. The years immediately following the Depression were a period of relatively conservative bank behavior, due in part to the natural caution of the surviving members of the industry, and also to the federal and state restrictions on competition and entry.

During the three decades from 1942 to 1972, banking behavior continued to be very conservative. In general, economic performance was favorable, with the number of business failures and the volume of loan losses low. By the 1950s the bank holding company vehicle was used increasingly to enter new product markets and circumvent branching restrictions.²⁶ (Through a bank holding company structure, banking organizations can diversify their assets and income streams by controlling subsidiary banks in different communities and other subsidiaries engaging non-banking activities.) The prominent example of this trend was Transamerica Corporation, the corporate parent of Bank of American, N.A. Transamerica acquired banks in several states as well as an insurance company and other financial services firms.

To restrain the circumvention of geographic and product line restrictions on banks and to address concerns about biased credit allocation, potential concentrations of financial power, and sales "tying", Congress enacted the Bank Holding Company Act in 1956. Section 3(d) of this Act, known as the Douglas Amendment, prohibited interstate bank acquisitions by bank holding companies unless expressly authorized by state law in the acquirer's state.²⁷ Section 4 allows the Board of Governors of the Federal Reserve System to regulate what activities holding companies may engage in. The Act permits the Board to approve only those activities that are "closely related to banking and a proper incident thereto" and are expected to "produce net public benefits." Through the Bank Holding Company Act, Congress intended to prevent banking firms from engaging in securities underwriting, insurance, and a host of other financial activities. Originally, the Bank Holding Company Act applied only to domestic bank holding companies that owned two or more banks, creating the one bank holding company (OBHC) loophole. Congress closed the loophole with the enactment of the One Bank Holding Company Act on December 31, 1970. With the enactment of the Banking Act on September 17, 1978, Congress included foreign banking concerns with domestic operations under the scope of holding company regulations.²⁸

The Period 1972-1980: Commercial banks and other depository institutions generally prospered within the traditional framework, well into the 1970s. But the environment for

commercial banks--which formed the basis of the market imperfection niche which its services uniquely filled--changed substantially in the last two decades, in the face of high inflation, volatile interest rates, technological innovations, the advent of vigorous new competition from insured and non-insured financial intermediaries, and the ad hoc reform initiatives of the states and regulatory agencies.²⁹ Thus, the efficacy of the regulatory process that the government has relied upon to control excessive risk-taking with deposit insurance has gradually eroded.

The value of the traditional banking franchise eroded on both sides of the balance sheet. Product innovations such as money market mutual funds (MMMFs), commercial paper, and loan securitization allowed bank and thrift customers to bypass the regulated banking system. On the liability side, banks increasingly felt the impact of disintermediation. MMMFs allowed consumers to enjoy the equivalent of a checking account earning a market determined interest rate while, at the same time, providing safety for the investor (no one has lost money in a MMMF). The development of the commercial paper market permitted large corporations, the traditional bread and butter customers of banks, to fund their short term credit needs directly.

The development of MMMFs in the 1970s had a profound effect on the industry. Through MMMFs, securities firms bypassed the deposit taking prohibition in Section 21 and competed directly with banks for short term funds. When market interest rates soared in the late 1970s, surpassing the regulatory ceilings mandated in Regulation Q, the American public transferred hundreds of billions of dollars from the banking system into MMMFs. The funds invested in MMMFs climbed from \$3 billion in 1977 to \$233 billion in 1982.³⁰

A similar picture emerged on the asset side of balance sheets. Most notable was the drastic change in the role of commercial banks as providers of commercial and industrial loans, the core of the traditional franchise.

Securities firms greatly expanded their commercial paper underwriting activities, and large corporations substituted commercial paper for short term borrowing from banks. The value of commercial paper issued by corporations increased from \$7 billion in 1972 to \$74 billion in 1987. Over the same period, commercial paper as a percentage of outstanding bank loans rose from 5.7 percent to 13.5 percent. Banks' share of the short-term credit market for corporations with more than \$1 billion in assets has fallen from 49 percent to 26 percent during the past ten years. Clearly, the expansion of the securities firms' commercial paper underwriting activities robbed banks of many of their "bread and butter" customers.

This process of disintermediation extracted about \$200 billion from the banking system in less than three years, creating a liquidity crisis for many banks and thrifts. To reduce this problem, the Federal Reserve began easing some of the deposit interest rate ceilings in the late 1970s. However, many thrifts portfolios were still primarily composed of 5 and 6 percent fixed rate 30 year home mortgage made in the 1960s and early 1970s.³¹ The easing of regulatory ceilings forced thrifts to fund loans with deposits bearing double digit interest rates. Unlike most banks, which protected themselves from interest rate fluctuations through the variable loan pricing and short loan maturities, the thrifts had borrowed short and lent long at fixed rates. The impact of high interest rate deposits on this financially unsound maturity mismatch caused more than one tenth of all American thrifts to be insolvent on a market value basis by 1980, before any financial "deregulation" legislation was based.

Further franchise erosion occurred in the home mortgage loan portion of banks and thrift assets by the burgeoning securitization of these loans. Securitization was a more efficient risk intermediation process than the traditional deposit-to-loan intermediation offered by the banks and thrift, both because it was lower cost and because it provided a better risk match between home mortgage borrowers and final investors. Banks and thrifts faced with this competition in their markets saw their profits reduced, from loss of market share and lowered rates, as new competitors, particularly mortgage bankers,³² began to originate and securities home mortgage loans for resale to investors.

The securitization process was transformed by federal intervention, which significantly lowered the risk of the derivative security. Three public sector agencies, the Government National Mortgage Association (Ginnie Mae), the rechartered Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac), were established to provide guarantees of full and timely payment of the principal and interest on mortgage-backed securities issued by private firms. In addition Fannie Mae (and Freddie Mac to a small extent) issued their own mortgage backed securities, and bought and sold home mortgages for their own portfolios, to support the secondary market. These agencies have dominated the secondary market for conventional mortgage loans.

The Past Decade: Crisis and Response

Congress correctly recognized that the disintermediation problem was so large and growing so rapidly that immediate action needed to be taken. To address the problem, Congress adopted two landmark deregulatory bills, the Depository Institution Deregulation and Monetary Control Act (DIDMCA) on March 31, 1980

and the Garn-St. Germain Depository Institutions Act on October 15, 1982. To stem the flow of funds away from regulated banks and thrifts to unregulated MMMFs, DIDMCA phased out all ceilings on deposit interest rates by March 31, 1986. To prevent a credit crunch during periods of high interest rates, DIDMCA overrode state ceilings.³³ DIDMCA also raised the statutory coverage of Federal deposit insurance from \$40,000 to \$100,000.

DIDMCA, together with Garn-St. Germain, significantly expanded the ability of thrifts to compete more directly with banks by allowing most of the thrifts to extend a limited volume of commercial, nonresidential mortgage, and consumer installment loans; issue credit cards; provide trust services; and accept checkable deposits. However, Congress maintained separate and unequal regulatory systems. For example, banks were forced to maintain a 6 percent capital ratio, but thrifts were required to have only 3 percent.³⁴

Congress correctly felt that excessive regulation had harmed the banks and thrifts and attempted to address some of the regulatory problems in DIDMCA and Garn-St Germain. However, congress failed to address the incentive problems of flat-rate, deposit insurance.

The pace of change since the early 1980s has accelerated. Two recent developments represent important breakdowns in market imperfections and have accordingly significantly impacted financial institution operations: (1) the explosive growth of asset securitization and contingent claims,³⁵ and (2) the internationalization of financial markets.

The growth in securitization and contingent claims and guarantees has led to a decline in the demand for bank credit services, in a manner parallel to the banks' loss of the commercial credit market in the previous decade. The demand has shifted toward securities firms and investment bankers skilled in the creation of derivative securities. In addition, because of the internationalization and integration of financial markets on both the borrower and lender side, U.S. financial institutions have also faced increasing competition from the foreign banking industry and could no longer count on the prices and availability of funds being "protected".³⁶

Developments in financial theory led to the separation of other services traditionally provided as a package by banks into their component parts, which represented a better match to investor needs, often at lower cost. For example, stripping coupons from bonds by separating the interest flows from the principal created different products suited to different investor risk needs. The process enabled the further development of products suited to particular needs by recombining the components into new products. For example, the use of credit enhancements

in the form of standby letters of credit and other types of guarantees have increased the acceptability of less known borrowers to investors.

On the liability side, securities firms began to compete for savers' funds by combining the sale of bank certificates of deposit with a wide range of other asset allocation services--typically in "cash management accounts" offered to customers. This development began to erode the monopoly on provision of payment services enjoyed by commercial banks. The dismantling of deposit interest rate controls in the 1980s, provided for in DIDMCA, largely completed the basic restructuring of bank liability portfolios, and eliminated part of the long-standing cost of funds subsidy enjoyed by traditional banks.³⁷

Finally, loan securitization began to erode the commercial banks' share of the consumer installment, credit card, and commercial mortgage markets. In the last ten years, mortgage backed securities issued by non-banking firms have increased from less than 8 percent to over 28 percent of total residential mortgage debt outstanding.³⁸ New installment-loan-backed and credit-card-backed securities may further erode the banks' share of these profitable markets.

Banks sought to compensate for these trends in a number of ways--by reconfiguring their traditional lending activities in favor of real estate, highly leveraged transactions, and loans to less developed countries, all of which promised greater yields and carried higher risks. They also sought profitability in off-balance-sheet activities, and by engaging in the securitization of assets (particularly mortgage-backed securities).

The changes in the economic environment and the increased competition adversely affected bank and thrift institutions. The business of banking became much less stable and profitable, as evidenced by declining return on assets, declining market share, declining equity value and increased failures.³⁹

The thrift industry, by the nature of its business, was severely impacted by the extraordinarily high interest rates of the early 1980s. Congressional deregulation of deposit interest rates and the authorization to offer adjustable-rate mortgages reduced the disintermediation but did not mitigate the overall impact of high interest rates on the industry. To shore up industry earnings and net worth, thrifts were allowed to expand into higher-risk lines of business in which they had little experience, while, at the same time, minimum capital requirements were lowered. The combination of undercapitalized growth into high-risk activities, regional economic depressions and insider abuse and fraud resulted in financial disaster for a substantial segment of the thrift industry.⁴⁰

Thrift Crisis and FIRREA: The thrift crisis confronted President Bush when he took office. On February 6, 1989, President Bush revealed the outline of his plan to bail out FSLIC and solve the thrifts crisis. The Bush proposal, "The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)," was enacted into law on August 9, 1989. FIRREA has three main components: (1) funding the FSLIC insolvency, (2) reforming regulation, and (3) punishing fraud.

1. **Funding the FSLIC Insolvency.** FIRREA established the Resolution Trust Corporation (RTC) to manage the orderly resolution of all thrifts which were insolvent on January 1, 1989 or might become insolvent through August 9, 1992.

FIRREA also established the Resolution Funding Corporation (REFCORP) to finance the RTC. REFCORP has issued \$50 billion in bonds, the proceeds of which were used to cover the losses in insolvent thrifts. This \$50 billion supplements the \$40 billion (present value) that the FHLBB previously committed to insolvency resolution. The banking and thrift industries and the taxpayers will share the costs of the cleanup.

2. **Reforming Regulation.** Under FIRREA, the Savings Association Insurance Fund (SAIF) was created to insure thrifts which fail after August 9, 1992. The FDIC fund was renamed the Bank Insurance Fund (BIF). Although the bank and thrifts deposit insurance funds remain separate, the administration of SAIF was placed under the FDIC. The FDIC was authorized to limit the activities of federally insured state chartered thrifts. The Office of Thrift Supervision, under the general supervision of the Secretary of the Treasury, was created to charter, regulate, and supervise all federal thrifts and to supervise state thrifts.

3. **Punishing Fraud.** Various civil and criminal penalties for willful misconduct were increased.

FIRREA focused upon funding the thrift cleanup and altering the regulation of thrifts. FIRREA did not change the incentive structure imbedded in the federal deposit insurance program. Both bank and thrift deposit insurance premiums were increased, but the rates were not adjusted for risk. Instead, FIRREA directed the Treasury to study banking regulation and, in conjunction with regulatory agencies and others, make recommendations for reform.

Where Do We Go From Here: Completing the Job

There are few serious observers of the American economy today who would not single out the financial services industry as

one of the most important areas for improvement. To allow our country to move forcefully into the next century, we need a strong, flexible, and efficient financial services industry.

The reforms needed to achieve this goal should address the four interrelated parts of the problem: (1) the reduction in competitiveness and financial strength due to outdated anti-competitive restrictions which prevent banking organizations from responding to the evolution of financial markets and technology; (2) the over-expansion of the scope of the current deposit insurance system, which reduces the discipline on bank risk-taking and creates excessive taxpayer exposure; (3) the current complex, duplicative regulatory system which often fails to take decisive action; and (4) the undercapitalized insurance fund, which provides too many incentives for regulatory forbearance, along with taxpayer exposure.

Restoring Competitive Efficiencies

The strength of our banking industry has been eroded by the failure to adapt banking laws to the evolution of financial markets. Reform is needed in several areas.

Geographic Deregulation: Interstate branching is a logical and feasible step in the evolution of the geographic structure of U.S. banking. It has several advantages: enhancement of safety and soundness, efficiency benefits through economies of scale in operations and payment processing, and increased consumer benefits through increased competition and convenience.

Safety and Soundness: By decreasing the opportunities for portfolio diversification, geographic restrictions increase the risk of individual bank failure. The historical record supports the assertion that branch banks have a better safety record than unit banks.⁴¹ The better safety record is due to the ability of a branch system to gather liabilities from, and transfer capital among, its individual units. Thus, a localized shock sufficient to cause a unit bank to become insolvent may be offset by funds transferred from outside the area. The ability to branch across state lines would extend the funds diversification, allowing bank branches to absorb regional shocks.

Increased Competition: Geographic restrictions could be justified if they produced offsetting public benefits such as maintaining competition in local banking markets. Proponents of geographic restrictions contend that without restrictions, a few large money center banks would monopolize the industry. However, a review of the evidence demonstrates that current geographic restrictions have actually reduced competition in local banking markets and encourage monopolistic behavior.

Evidence reveals that complete geographic deregulation would

enhance competition, significantly increasing the number of potential entrants into local banking markets. Since allowing interstate banking would make it less costly to enter a state, banks would be more likely to enter to take advantage of profitable lending opportunities. Rather than acquiring leading banking firms, many bank holding companies may choose to enter new markets through a "fringe" entry -- the acquisition of a small bank with only a minor share in a local banking market. Because a parent holding company can supply the acquired bank with more financial and technical support than it could have obtained as an independent institution, the acquired bank may be able to expand its market share very rapidly. Fringe entry by a large bank can have a greater competitive impact in local banking markets than its small local market share would suggest.⁴²

Proponents of geographic restriction further argue that branches would siphon funds out of an area; this is unlikely if profitable lending opportunities exist in the area. The evidence tends to support the argument that branching advances competition without diverting credit from local economies.

Economies of Scale: A number of studies both here and abroad support findings of economies of scale at depository institutions over a wide range of institutional size.⁴³ This suggests the removal of geographic restrictions would result in a significant increase in efficiency. The payments system area in particular holds considerable room for improvements. With consolidation of a number of separate units into a branch network, more clearing could take place internally. In addition, the consolidation of reserve accounts would lower administrative costs associated with payment processing.

The removal of geographic restrictions would speed interbank funds movement and increase economic efficiency. In a system of mainly unit banks, a check drawn on one bank and then deposited at another unaffiliated bank often has to pass through a chain of correspondent banks clearing houses before it returns to its bank of origin. The clearing process can consume considerable time and resources. Wider branching that would develop after geographic deregulation would turn many costly interbank check payments (transit items) into less expensive internal funds transfers within the same bank (on-us items). As endpoints are consolidated, banks can reduce the sorting and handling costs of the remaining transit items and realize transportation economies through the direct exchange. The volume of transit items moving through clearing houses or correspondent banks would decline. While difficult to estimate, the cost savings could, nevertheless, be substantial. And since many non-check payments, especially large dollar wire transfers, could also be internalized, there would be additional savings.

Customer Convenience: Both consumers and businesses would

benefit from the increased convenience offered by geographic deregulation. Currently, consumers must select a new bank when they move from one state to another or even from one community to another if they live within a unit banking or restricted branching state. Often consumers have very little information on which to evaluate banks they may have never heard of before. Geographic restrictions force consumers to incur considerable search costs to select a new bank. Removing these restrictions would allow many customers who move from the state to another merely to transfer their records to another branch in their new community. Geographic deregulation would also allow business firms with operations in many states to simplify their banking relationships and reduce cash management costs. Currently, business firms, especially those handling large amounts of cash such as retail stores, must open checking accounts with commercial banks in each state in which they operate. Indeed, in unit banking or restricted branching states, they must open accounts in every community. The absence of branch facilities imposes significant cash management expenses on such businesses. Geographic deregulation would relieve businesses of this heavy burden.⁴⁴

Product Line Deregulation: The relaxation or complete removal of product line restrictions offers the same promise of competitive efficiencies as geographic deregulation.

Securities Activities: Commercial banking and investment banking are complementary activities and the separation of these activities in the 1930s by the Glass-Steagall Act was unnecessary, especially given the securities markets reforms of that era. Commercial banks have gained and now possess the skills and experience required for undertaking the full range of securities activities, which explains the persistent erosion of the Glass-Steagall Act. They have been traditionally involved in making judgments about credit quality, future prospects and potential impact of financing. They also engage in functions similar to the securities distribution function of investment banks. Banking organizations have gained considerable experience in underwriting municipal securities and in underwriting and dealing in corporate securities abroad.⁴⁵ Indeed banks now have the ability to engage in a broad range of securities activities (although with numerous restrictions), suggesting that there would be considerable economies of scope between commercial banking and other securities activities. Furthermore, there is potential for reduction in overall risk. Studies suggest that securities underwriting is no riskier, and may be less risky than commercial banking. also, underwriting risk is determined to a large extent by the ability of the firm.⁴⁶ In addition, whatever the risk in securities underwriting, the risk in a diversified financial services firm is reduced through the diversification process.

The potential for conflict of interest or other abuses, arising from a bank's interest in its securities affiliate and responsibilities to depositors and trust beneficiaries, has been a subject of concern. In particular, a commercial bank affiliated with a financially troubled securities firm may be induced to make questionable transfer to its affiliate, and as a result may jeopardize the safety of the bank. However, banks face both internal and external economic disincentives to exploit the potential conflicts.⁴⁷ Also, a combination of holding company separation, existing limitations on abuses (e.g. anti-tying restrictions) and new restrictions targeted specifically toward preventing abuses can adequately allay these concerns. For example, while a bank or bank holding company may be tempted to assist a financially troubled affiliate, the ability to do so is restricted under current "firewall" requirements, established to limit transactions between the bank and securities affiliates.⁴⁸

Insurance Activities: Second to securities activities, insurance is considered the financial activity closest to banking. Like banking, insurance is a financial intermediation process--taking premiums from a large retail base, investing the funds in financial assets and loans, and repaying the proceeds to the liability holder. Insurance products are highly complementary to many existing bank products, offering the opportunity for greater customer convenience and delivery cost efficiencies.⁴⁹ Although questions about unifying banking and insurance have been less well studied than geographic restrictions, securities underwriting, and deposit insurance, the studies that exist suggest allowing banking firms to sell and underwrite all forms of insurance would increase competition and lower premium costs to consumers.

In the United States, there are over 2,000 life insurance underwriters with total assets exceeding \$900 million and nearly 3,500 property/liability insurance underwriters with total assets exceeding \$310 million. These underwriters have traditionally distributed their policies through a network of agents, brokers, and company representatives. There are currently over one-half million agents, brokers, and service personnel in the U.S. Recently, many underwriters have begun to seek alternative, more efficient distribution systems for their policies.

In a 1987 study of the effects of bank entry into insurance markets, the Consumer Federation of America (CFA) compared the costs of existing policies available through both insurance agents and banks and found that savings banks and brokers based in banks offered policies that were consistently lower in costs. The CFA estimated that excluding banks from selling life insurance cost consumers from \$5 billion to \$10 billion in additional premiums annually. The CFA study also found that banks are more responsive to consumer requests for information

than captive or independent agents.

The CFA study found evidence in economic literature and other empirical studies that banks have lower production costs than other insurance agents and could pass these savings onto consumers. The CFA study concluded "[t]here is no reason to prohibit states from carefully expanding bank sale of insurance or federal authorities to dismiss bank sale of insurance out of hand."

A study completed recently by the General Accounting Office (GAO) also found that the selling of insurance by banks would prove beneficial to consumers through reduced costs and increased convenience. In addition the GAO found that such selling would promote competition in insurance markets with no risk to the safety and soundness of banks.

Summary: Advances in technology and increasing customer sophistication continue to create a demand for new products deliverable on both a national and international scale, eroding the market failures in intermediation and pushing toward the convergence of financial and commercial activities. Efforts have been made by banks to respond to these persistent market forces by expanding into activities highly complementary to their core business. Similar diversification efforts have been made by other financial service providers and by nonfinancial commercial firms.

A large number of diversified firms reflecting this trend are now in existence, the result of statutory and regulatory "loopholes" or gaps. These firms benefit the economy at large, providing cost efficiencies, offering a wide range of diversified products to consumers, and strengthening the capital positions of the financial services subsidiaries. However the "loophole" approach has meant that the successes have often been achieved in a piecemeal, inefficient, irrational manner. Long-standing regulations have prevented all types of financial institutions from structuring their portfolios to realize the full range of natural efficiencies, restraining their ability to respond to the marketplace developments.⁵⁰

Financial services modernization is needed to permit financial services firms to respond fully to the erosion of market regulation. The major objective of any financial restructuring must be to insulate the insured bank so that the federal safety net is not exposed to nonbanking activities. The insulation is also important to prevent the transfer of safety net subsidies from the bank to its affiliates. But excessive legal restrictions can largely defeat the benefits by eliminating any synergies associated with providing a diversified range of products. The firewalls applied should be the minimum needed to accomplish the policy objectives.⁵¹

Other critical policy objectives to be achieved by modernization include (1) enhancing the overall safety and soundness of the financial system, (2) increasing efficiencies, and (3) positioning U.S. financial institutions as stronger competitors. Financial modernization would enhance the safety and soundness of the financial system and correspondingly bring additional efficiencies to the economy, by allowing the banking industry to evolve with the marketplace, both domestically and globally.

Deposit Insurance

Deposit insurance provides important economic benefits which the market could not achieve on its own: the protection of small depositors and the prevention of widespread bank runs. Bank runs interfere with the money supply process, the payments system, and the banks' intermediary role of supplying credit to illiquid investment projects.⁵²

However, events have demonstrated that some of the criticism leveled earlier against the concept of federal deposit insurance had merit. The system has subsidized highly risky, poorly managed institutions, which have exploited the federal safety net by funding speculative projects with insured deposits. The resulting costs have been borne by well-run institutions and by taxpayers. Serious flaws in the nature of the insurance are in part responsible. Chief among these are the risk incentives inherent in the insurance structure, the scope of the coverage, and the rules governing premiums paid by the banks. Finally, the increasingly untenable competitive position of insured depositories within the domestic and international economy increases the risk to the fund.⁵³

Risk Discipline Problems: The debate on the risk incentive problems with deposit insurance focuses on what is known as the "moral hazard" problem.⁵⁴ That is, to the extent that bank depositors are protected by the insurance system (including the de facto insurance provided by the failure resolution policies of the insurance agencies), there is no incentive for them to be concerned with the condition of the bank. In fact, because their deposits are riskless, they are motivated to seek out the highest return, in a process known as "reverse runs". Thus the risk discipline normally provided by the market is reduced.

Another dimension to the moral hazard problem is the incentive facing undercapitalized institutions. If a bank's equity is significantly eroded by losses, so that it is near insolvency, its equity owners have less and less to lose and more to gain by the pursuit of highly speculative projects which offer small chances of large rewards. Thus the bank may in effect seek out projects offering undue risks, exposing the fund to greater

losses if the projects fail.

Because the insured depositors (and uninsured to the extent they believe themselves to be covered de facto) provide no discipline to bank risk-taking, it is argued that the discipline could be alternatively provided (without reducing the scope of coverage) by structuring the premiums to reflect the risk of the bank's activities.

However, the optimal structure is not easily determined. Simply setting the overall level has efficiency implications for the economy: too low a level allows banks to gather excessive amounts of funds, permitting the industry and the credit segment it serves to grow beyond the most efficient size. Too high a level has the opposite effect, penalizing banks and their borrowers. Furthermore, the appropriate risk structure of the premiums is likely to be difficult for the regulator to gauge accurately: as indicated above, banks lend to credit sectors for whom credit information is difficult and costly to obtain. Thus the regulator, not having the information needed to make the proper credit evaluation, will not have the ability to set the premiums appropriately, and the risk incentive will be accordingly distorted.

This problem may be alleviated by incorporating market **assessments**. Unlike regulators, market insurers would be free from political pressures to underprice insurance and keep open an insolvent institution.

Bank supervision provides additional risk deterrence and helps provide a substitute for the market discipline removed by deposit insurance. Supervision relies on four primary elements to control risk--capital standards, closure rules, examinations and corrective and punitive enforcement actions. The success of the supervisors' efforts depends upon the quality of the information available to them to enable them to identify potential loss, upon the adequacy of their powers to force correction or prevent further deterioration, and upon prompt action once the identification of loss potential has been made. Recent insolvencies have caused a number of observers to raise concerns about these factors. Observers also note that the incentives for regulators to prevent risk-taking may be weaker than the incentives of bankers to take risks.⁵⁵

Reducing the Scope: Reducing the scope of coverage involves increasing depositor discipline, which raises two issues. The first is the size of this "trade-off" between stability and depositor discipline--the extent to which this additional exposure of depositors will increase financial instability. The second is the extent to which the coverage is in fact reduced (the de facto coverage problem). A third issue is also present--the extent to which small savers are protected. However, the

range of coverage considered in any reform effort will in all likelihood be sufficient to protect small savers.

Two alternative perspectives exist on the dimensions of the trade-off. The need for deposit insurance flows from the view of banks as "special". This view suggests that any significant threat of banks runs should be avoided because even a threat will inefficiently distort the services they provide to the economy.

Furthermore, proponents of this view argue that depositor or market discipline cannot prevent distortion. (As indicated above, banks lend to borrowers for whom information is costly to obtain; thus depositors (or others) are not likely to possess information sufficient to make a complete credit evaluation of the bank's assets.)

The alternative perspective views the cost of bank runs as the short-run price that must be paid for long-run stability. In this view, depositor (or some other market) discipline is essential for the long-run; without depositor discipline, the economy must rely on forms of bank risk control that do not work. In addition it is argued that banks are less "special" than before, particularly in the provision of credit. In this view the instability of bank runs poses less economic risk to the economy than the absence of some form of discipline.

Difficulties arise in weighing the cost and benefits associated with changes in either direction. Perceptions of the costs associated with nonsystemic bank runs and with probabilities of system disruption differ and are hard to measure objectively. Proponents of the view that excessive coverage poses the greater threat would point to the debacle in the thrift industry as proof. The evidence on the effectiveness of depositor discipline is mixed. The weight of the evidence, however, suggests that uninsured depositors have probably provided some discipline through risk premiums on various bank liabilities.

Summary: Recent experience suggests the need for greater market discipline from depositors. Since the 1930s the scope of coverage has vastly increased, directly improving system stability and decreasing depositor discipline. At the same time, failures have risen dramatically. This suggests that the current trade-off errs in the direction of stability, so much so that the health of the system is itself harmed. More market discipline will curb risk institution behavior and reduce the risk of failure, even in a regime in which uninsured deposits are sometimes protected.⁵⁶

Conclusions

The disruptions caused by bank runs are several-fold: the

disruption of the money creation mechanism which impacts monetary policy, the payments mechanism, and the supply of credit to sectors of the economy uniquely served by banks. Studies suggest that deposit insurance is the most efficient way to prevent market failure.

Deposit insurance provides important economic benefits. Private insurance could achieve the same benefits. Insurance controls the instability resulting from bank runs by alleviating the "contagion" effect, by which the **ability** of other banks to make good on deposits are impacted by an individual bank failure. In addition insurance protects the small, unsophisticated investor.

Yet the current system of deposit insurance is overextended, exposing taxpayers to substantial losses. Narrowing coverage would reduce taxpayer exposure without reducing the basic protection for small depositors, and would reintroduce a level of risk discipline by larger sophisticated investors. In addition the insurance function must be strengthened at the individual bank level, by increasing the role of capital and providing for risk-based insurance fund premiums--to reduce the "moral hazard" problem discussed above-- and improving regulatory supervision. A streamlined, efficient regulatory system would further supplement market discipline and apply prompt corrective action to weak and unsound institutions. The current insurance fund must be recapitalized to improve the process of resolving failed institutions. At the same time, opportunities to participate in the full range of financial services should be made available to well-capitalized banks through geographic and product line deregulation--but outside the federal safety net. In the end, the most effective way to reduce exposure is the creation of a competitive, well-capitalized banking system. All components of reform are needed to increase banking competitiveness and create a sound diversified financial services system.

1. Edwards, "Can Regulatory Reform Prevent the Impending Disaster in Financial Markets?", Restructuring the Financial System, A Symposium sponsored by the Federal Reserve Bank of Kansas City, 1987, p. 4.
2. Eisenbeis, Ibid., pp.23-24.
3. Eisenbeis, Ibid., p. 24.
4. Furlong and Keeley, "The Search for Financial Stability" in The Search for Financial Stability: The Past Fifty Years, A Conference Sponsored by the Federal Reserve Bank of San Francisco, 1985, p.216.

5. Furlong and Keeley, Ibid., p. 221-224.
6. Furlong and Keeley, Ibid., pp. 224-5.
7. Furlong and Keeley, Ibid., p. 225.
8. Eisenbeis. Ibid., pp. 34-35.
9. Eisenbeis, Ibid., p. 35.
10. Ely (1988), p. 51-54.
11. Friedman and Schwartz (1963), p. 351.
12. Product line restrictions can actually increase such risk. For example, Congress confined thrifts into a fundamentally unsound "borrow short, lend long at fixed rates" business, as later events demonstrated
13. Even then, the Bank of the United States had a securities affiliate that was merely used as a front for the fraudulent activities of its president. It never conducted brokerage or underwriting activities for the public.
14. White (1986), p.40.
15. Department of the Treasury, Modernizing the Financial System, Recommendations for Safer, More Competitive Banks, 1991, pp. XVIII-5 - XVIII-7.
16. Treasury, pp. XVII-4 - XVII-7.
17. Ironically, the local concentration in loan portfolios that geographic restrictions produce has been a major historical cause of bank and thrift failures in the United States.
18. Treasury, Ibid., p. XVIII-7.
19. The current coverage limitation for deposit insurance is \$100,000.
20. Treasury, Ibid., pp. I-31ff.
21. Congress did not originally conceive of federal deposit insurance as a consumer protection measure. Indeed, deposit insurance was considered a macro-economic tool to prevent a system-wide bank run and the accompanying monetary contraction due to the sudden withdrawal of reserves from the banking system.

22. Most economists recognize that the Federal Reserve System, acting as lender of last resort, can prevent a system-wide bank run. Deposit insurance is useful in preventing a system-wide bank run, only if the Federal Reserve System fails to provide adequate liquidity to the banking system, as it did during early 1933.

23. From the beginning, most economists realized that a flat rate premium produced a moral hazard problem among bank and thrift owner/managers. A flat rate premium allows a bank or thrift with a preference for risk taking to enjoy the potential benefits of risky investments while spreading the cost of its risk taking equally to all premium payers (i.e., other banks and thrifts). The intensity of the moral hazard problem is inversely related to the size of a depository institution's equity capital. When a bank or a thrift has substantial equity capital relative to its assets, owner/managers are unlikely to undertake inordinate risk because a significant amount of their own funds are at stake. When the market value of equity capital declines, however, the moral hazard problem escalates. Owner/managers can engage in "bet the bank" behavior by making risky loans and investments in hope that they will pay off. If the owner/managers win, they retain a profitable banking or thrift franchise. If not, then federal deposit insurance socializes the losses.

24. Treasury, p. I-4.

25. Such regulations include minimum capital requirements, activity prohibitions, and legal lending limits to any single customer and his related interests. Banks and thrifts are examined by their respective primary federal regulator, at least once every two years and often more frequently, to review their financial condition and determine their compliance with any of these regulations. If a bank or thrift is not in compliance with any of these regulations, the regulator may attempt to enforce compliance through (1) denial of pending regulatory applications, (2) moral suasion, (3) voluntary compliance agreements, (4) cease and desist orders, and (5) removal of senior management.

26. Treasury, Ibid. pp. I-18 and XVII-7.

27. The bank holding company is a parent corporation that controls one or more commercial banks and may engage in certain other bank-related financial activities through nonbank subsidiaries.

28. Foreign banking organizations that are entering the American market for the first time face less restrictive geographic constraints than do their existing American competitors because a foreign banking organization may acquire its first American bank in any state. However, all subsequent acquisitions and branching are governed by the same geographic restrictions as American banking organizations.

29. Treasury, Ibid., p. XVIII-9.
30. Litan (1987), pp. 34-35.
31. Thrifts were not allowed to make variable rate home mortgage loans until 1980.
32. Mortgage bankers originate home mortgage loans and sell them as mortgage backed securities in the secondary market to individuals and institutional investors such as pension funds and life insurance companies. Mortgage bankers collect the principal and interest payments on the underlying mortgage loans and transmit these payments to the owners of the mortgage backed securities.
In contrast, thrifts historically have originated home mortgage loans for their own portfolio. Within the last decade, some of the more competent and well managed thrifts have begun to package their mortgage loans for sale on the secondary market like mortgage brokers.
33. States were allowed to reenact usuary laws. Although most did, the new laws generally provided for floating ceilings tied to market determined interest rates so that the new laws are generally nonbinding.
34. Capital is defined as the book value of common stockholders' equity, loan loss reserves, and certain preferred stock and subordinated, long term debt instruments. The exact definition of capital varies among the regulatory agencies. The capital ratio is the ratio of total capital to total assets.
35. Eisenbeis, Ibid., pp. 25ff.
36. Eisenbeis, p. 227ff.
37. Treasury, Ibid., p. XVIII-10.
38. Glass-Steagall Act Reform (1988), Exhibit 2.
39. Treasury, pp. XVIII-11 - XVIII-12, and I-25 - I-27, and accompanying figures I-5 - I-13.] Mismanagement and, in some cases, fraud, also played a significant part. [Treasury, p. I-24.
40. Treasury, pp. I-19 - I-20.
41. Treasury, p. XVII-8.
42. Calem (1987), p.10.
43. Murray and White (1983); Shaffer and David (1986); Kuroda and Kaneka (1986); Goldstein, McNulty, and Verbrugge (1987); and Shaffer (1988).

44. Becker, Horwitz, and O'Quinn (1987), p. 7-8.
45. Treasury, pp. XVIII-13ff.
46. Treasury, p.XVII-14.
47. Saunders (1985), pp. 221-222.
48. Section 23A of the Federal Reserve Act, added in the banking Act of 1933 and strengthened in the garn-St Germain Depository Institutions Act of 1982, restricts credit extensions and similar transactions between the FDIC insured banks and their affiliates. Section 23A limits "covered transactions" between an FDIC insured bank and any affiliate to 10 percent of the bank's capital stock and surplus. Moreover, the total of "covered transactions" with all affiliates is limited to 20 percent of the bank's capital stock and surplus. "Covered transactions" under this section include any loan to an affiliate, any guarantee or letter of credit issued on behalf of an affiliate, any purchase of securities issued by an affiliate, any purchase of assets from an affiliate, including assets subject to a repurchase agreement, and the acceptance of securities issued by an affiliate as collateral for any loan by any person or corporation. Section 23a requires that every "covered transaction" be "on terms and conditions that are consistent with safe and sound banking practices." The section mandates that every credit extension to an affiliate must be fully secured by liquid collateral in proper margin. Section 23A also forbids a bank from purchasing "a low quality asset from an affiliate unless the bank ... ,pursuant to an independent credit evaluation, committed itself to purchase such asset prior to the time such asset was acquired by the affiliate."

Section 23B was added to the Federal Reserve Act in the competitive Equality Banking Act of 1987 to impose additional limitations on a wider range of transactions between an FDIC member bank and its affiliates. Section 23B applies not only to all transactions covered by Section 23A but also to the sales of securities from a bank to an affiliate, the payment of money or the furnishing of services by a bank to an affiliate, and any transactions in which an affiliate acts as a broker or dealer for a bank. This section also covers any transaction with a third party when an affiliate has an interest in the transaction or receives the proceeds from the transaction. Section 23B requires that all transactions between a bank and its affiliates covered under either Section 23A or 23B must be on an "arm's length basis" under terms and conditions substantially the same as those prevailing in the market place. Section 23B prohibits a bank from purchasing any security during the underwriting period for which an affiliate has acted a s principal underwriter unless the purchase is specifically approved by a majority of the bank's board of directors. Section 23B forbids a bank from advertising that it has responsibility for the obligations of an affiliate.

49. Treasury, pp. XVIII-16ff.
50. Treasury, pp. XVIII-22ff.
51. Treasury, pp. XVIII-29ff.
52. Treasury, p. I-11.
53. Treasury, pp. I-11ff.
54. Treasury, Ibid., I-12.
55. Treasury, pp. III-6 - III-7.
56. Treasury, p. III-10.