31. Banking and Financial Services

Congress should

- enact reforms allowing commercial banks to provide a universal range of financial services, including insurance, underwriting, merchant banking, and securities brokerage;
- phase out federal deposit insurance;
- privatize the clearing services that Federal Reserve Banks currently provide to commercial banks;
- eliminate reserve requirements; and
- repeal the Community Reinvestment Act.

The Agenda for Banking Reform

In recent decades Congress has begun the job of dismantling the statutory and regulatory barriers to sound, competitive, and innovative banking, many of which were erected in the 1930s. Deposit interest ceilings for consumers were removed in the 1980s. (A zero interest ceiling on the checking accounts of businesses remains to be eliminated.) The FDIC Improvement Act of 1991 took a tentative first step toward defusing the moral hazard bomb of federal deposit insurance by allowing premiums to be somewhat risk adjusted. The phased-in provisions of the Neal-Riegle Interstate Banking Act of 1994 have finally lifted geographic (branching) restrictions. To give American consumers and businesses access to fully modern and efficient financial services, Congress must finish the job.

Although progress in modernizing the banking statutes has been made, the financial marketplace has been changing even more swiftly. Computer technology and the Internet are revolutionizing information processing, communications, and the design of financial market products (such as new forms of mortgage loans, mutual funds, and derivative securities). The associated trend toward ''globalization'' means that it is progressively

easier for market participants to move business from domestic institutions that are limited by outmoded laws to offshore competitors. Legal restrictions on the scope of bank activities, particularly the Glass-Steagall Act, have become increasingly harmful to banks and their customers. Those restrictions are preventing synergistic improvements in financial services that would otherwise be attainable.

The prospects are good for the 106th Congress to enact universal banking reforms. In May 1998 the House of Representatives passed H.R. 10, the Financial Services Act of 1998, which would have repealed significant parts of Glass-Steagall and allowed qualifying holding companies to engage in underwriting, insurance, securities dealing, and merchant banking. Although the bill failed in the Senate, the Senate has in recent years approved other legislation for financial modernization, including repeal of Glass-Steagall, as Alan Greenspan, chairman of the Federal Reserve System, noted in his testimony urging Senate passage of H.R. 10.

Strengths and Flaws of H.R. 10

On the plus side, H.R. 10 would have repealed Glass-Steagall and allowed banks to sell insurance, to underwrite municipal securities, and to affiliate with existing insurance companies. It would have allowed some mixing of commercial banking with general underwriting and merchant banking. Those provisions would have increased the scope for competition to best serve consumers, allowing ''financial supermarkets'' to provide innovative combinations of services at lower cost.

Unfortunately, the act did not go as far toward an open financial marketplace as it could have. The 106th Congress should consider a bill that differs in these areas: (1) H.R. 10 insisted on the ''financial holding company'' as the exclusive institutional structure, instead of also allowing the universal bank. Given the legitimate concern that deposit insurance should not subsidize an even wider range of risk taking, that is perhaps understandable. But this concern points to the fact that deposit insurance is not yet properly priced. Ultimately, Congress needs to privatize and let competitive markets price deposit insurance, which would obviate the need to construct artificial ''firewalls'' to limit the subsidization of risk taking. Financial firms would then be free to choose the most appropriate and cost-effective institutional structure. (2) H.R. 10 did nothing to allow the affiliation of banking with nonfinancial lines of business (''commerce''). Again, this is an area in which market forces should not be preempted. If the existence of federal deposit insurance is the rationale for not removing this restriction, that points again to the

need to remove federal deposit insurance. (3) By requiring that a financial holding company have a ‘‘satisfactory’’ CRA rating if it is to gain expanded powers, H.R. 10 would have added teeth to the Community Reinvestment Act, which should be repealed. (4) H.R. 10 would have expanded the power of the Federal Home Loan Banks to lend to commercial banks. Banks should borrow from one another at market rates, not from federal regulators at nonmarket rates.

Are Banks ''Special''?

Current federal bank regulatory agencies—the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision—have an interest in maintaining the view that banks are ‘‘special’’ in some sense that calls for their oversight. Banks (including commercial banks, thrifts, and credit unions) are in fact simply one subset of financial intermediaries—firms that lend other people’s money. Other intermediaries include mutual funds, insurance companies, pension plans, and finance companies. Banks also provide payment services by allowing customers to write checks on their accounts, but so do money-market mutual funds. The uniqueness of banks today lies, not in the roles they play, but in the legal restrictions and privileges with which they operate.

The current set of legal restrictions on American banks is mostly the legacy of a long history of geographic fragmentation, and restrictions on portfolios, which made the U.S. banking system needlessly fragile. Fortunately, that geographic fragmentation is now coming to an end. Here the 106th Congress needs to be wary of attempts to slow the market’s progress toward interstate banking, either through antitrust action against bank mergers or through initiatives to subsidize local banks. In the Great Depression, government-induced fragility was mistaken for something that could be remedied by yet more legal restrictions and federal deposit guarantees. Contrary to what was taken for granted in 1935, modern research indicates that less restricted banking systems, without taxpayer-backed guarantees, are more stable as well as more competitive. Restrictions on competition, ostensibly to make banks safer, protect incumbent banks to the detriment of consumers.

The keys to avoiding instability in the financial system are to liberate banks from legal restrictions that weaken them and to avoid severe instability of monetary policy. The banking crises of the 1930s and the 1980s were both due to monetary policy shocks.

This is not to say that banks need no supervision, no certification of their solvency and liquidity. The question is, Who should provide certification? Experience indicates that industry self-regulation, through private commercial bank clearinghouses, is more effective than adversarial federal regulation. Just as the New York Stock Exchange monitors the solvency and liquidity of those who hold seats on the exchange, because all exchange members have a strong interest in avoiding defaults, commercial bank clearinghouse associations were historically responsible for certifying the solvency and liquidity of their clearing members. The Federal Reserve System nationalized those functions. It is time to consider reprivatizing them.

Deposit Insurance Reform

The collapse of the Federal Savings and Loan Insurance Corporation a decade ago and the near-insolvency of the FDIC in 1991 have alerted us to the unnecessary dangers and expense of federal deposit guarantees. Despite Congress's mandate to the FDIC, in the FDIC Improvement Act of 1991, to graduate premiums according to risk, federal deposit insurance is not market priced. Taxpayer-backed FDIC insurance continues to subsidize risky bank behavior.

Deposit insurance props up a payment system that links checking accounts to fixed-dollar bank deposits that can be withdrawn on demand, and hence are potentially exposed to runs. Many economists have noted that there is a more stable alternative. Checkable money-market mutual funds are run proof, without deposit insurance. Consumers are protected, not at the expense of taxpayers, but by the transparency, diversification, and flexibility of mutual funds. To provide a level playing field for competition between banks and money-market mutual funds, Congress should (1) privatize deposit insurance to make it truly self-financing without any taxpayer subsidy and (2) privatize the Fedwire payment-clearing system, so that mutual funds can seek clearinghouse membership and thereby direct access to Fedwire or its private equivalent. Congress should look for direction to countries such as New Zealand that have moved away from deposit insurance. New Zealand's commercial banks operate without federal deposit insurance and jointly own the interbank clearing system.

Electronic Payments and ATM Networks

The Federal Reserve wisely decided in the 1960s not to get involved in the clearing of credit card transactions. Visa, MasterCard, and American

Express were therefore free to develop state-of-the-art systems for clearing and for the management of payment risks. Congress should see to it that the Fed follows the same hands-off policy toward developments in point-of-sale electronic payments, Internet payments, and digital currency media. Congress should resist the special-interest pleading of banking industry groups that only chartered banks should be allowed to provide prepaid cards (like ''Visa Cash'' or MasterCard's Mondex) or electronic payment accounts.

Congress should resist calls by short-sighted ''consumerists'' to regulate the pricing of automated teller machine services. As John Charles Bradbury notes, ''Since the imposition of surcharges for the use of automatic teller machines became widespread in 1996, the number of ATMs has increased significantly. That increase has benefited consumers greatly by making bank transactions more easily accessible.'' If it could not recoup its costs through surcharges on customers from other banks, a bank would have insuffcent incentive to install ATMs in every location where the total benefits to all potential users exceed the costs. Too few ATMs would be installed, and ATM networks would return to their underdeveloped state of a few years ago. Consumers who wish to avoid surcharges are free not to patronize the machines of banks that charge them. They should not deny access to other consumers who sometimes find the fees worth paying. As Bradbury writes, ''A ban on ATM surcharges . . . would serve only to deny an important timesaving option to consumers who are willing to pay for the convenience of ATMs.''

The Community Reinvestment Act

The Community Reinvestment Act should be repealed. In its current form, requiring federal regulators to ''rate'' institutions, subjectively and arbitrarily, on how satisfactorily they ''meet the credit needs'' of the neighborhoods where they gather deposits, the act is largely a costly nuisance. It requires reams of paperwork but has no demonstrable impact on the geographic allocation of credit. Where profitable investments are present, banks are already lending. Where absent, they are not currently required to lend (and shouldn't be).

To give the CRA ''teeth,'' for example, in the form of a required ratio of local loans to deposits, would be even worse. It would seriously misallocate credit, diverting it from high-payoff to low-payoff projects, and in the long run it would have the unintended but harmful consequence of leading banks to withdraw branches from low-income neighborhoods

that lack profitable lending opportunities. Competition among banks (and other lenders) able to serve a neighborhood is now on the increase with interstate branching. Such competition is the best force for making sure that banks distribute credit to all creditworthy borrowers and do not discriminate according to arbitrary boundaries or other invidious criteria.

Reserve Requirements

In the 105th Congress, a Senate bill (S. 1405) would have allowed the Federal Reserve to pay interest on the required reserves that commercial banks hold in the form of deposits at the Federal Reserve Banks. While payment of interest on bank balances at the Fed (total balances, not just those used for meeting reserve requirements) would be an improvement, Congress should also eliminate reserve requirements. Banks are increasingly using computer programs to avoid reserve requirements, ''sweeping'' reservable account balances overnight into nonreservable instruments, and sweeping them back in the morning. Between 1993 and 1997 commercial banks used such tactics to cut their required reserve balances from $28 billion to $9 billion, and further reductions are expected, implying that reserve requirements are raising less and less revenue. The resources consumed in sweeping could be saved by simply eliminating reserve requirements. Many other industrialized countries have already eliminated reserve requirements. They are not needed for monetary control; they serve only as a distortionary (but increasingly ineffective) tax on consumers who hold bank deposits.

Conclusion

Technological progress and globalization in financial services make regulatory modernization in the United States more urgent than ever. Legal restrictions and deposit guarantees, imposed decades ago, are not the path to safety, soundness, or better service for consumers. Continuing the progress of financial deregulation will benefit American business and consumers.

Suggested Readings

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