CATO HANDBOOK FOR CONGRESS

POLICY RECOMMENDATIONS FOR THE 108TH CONGRESS

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21. Financial Deregulation

Congress should

- repeal the Community Reinvestment Act of 1977,
- reject the Federal Deposit Insurance Reform Act of 2002 (H.R. 3717) that calls for increasing the deposit insurance limit to $130,000 and gives the Federal Deposit Insurance Corporation greater discretion in the setting of insurance premiums,
- enact the Bankruptcy Abuse Prevention and Consumer Protection Act of 2002 with stronger provisions, and
- revoke Fannie Mae's and Freddie Mac's federal charters and fully privatize those two government-sponsored enterprises.

With the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, which removed ceilings on deposit interest rates, Congress began a gradual dismantling of the regulatory barriers that, since the Great Depression, had made the financial services industry among the most regulated sectors of the U.S. economy and the U.S. financial sector among the most regulated in the world. That regulatory burden also made the financial services industry unnecessarily fragile. The deregulatory trend continued with the Federal Deposit Insurance Improvement Act of 1991, which introduced some risk sensitivity to deposit insurance premiums; the Neal-Riegle Interstate Banking Act of 1994, which established nationwide banking networks by removing the geographic restrictions on branching; and the Gramm-Leach-Bliley Act of 1999, which repealed much of the Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956, created financial holding companies, and ended the artificial separation of insurance companies and commercial and investment banks. Some changes were just the legal recognition of something that was already happening in the marketplace. For instance, the computer and telecommunications revolution made geographic branching restrictions obsolete. Other changes, such as the ones to the FDICIA, were a reaction to crises precipitated by the existence of previous regulations. But while Congress deserves to be congratulated for its past efforts, there is much work left to do to eliminate the inefficiencies and risks created by previous regulations and to allow U.S. financial firms to give consumers the full range of financial services they demand.

The Community Reinvestment Act

One of the major shortcomings of the Gramm-Leach-Bliley Act is that it did not end the Community Reinvestment Act of 1977, a law enacted to encourage banks to help meet the credit needs of their entire communities, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of banks. To the contrary, it gave the CRA more ''teeth'' by requiring that institutions have a satisfactory CRA rating before a merger involving those institutions can take place or before they engage in any of the new financial activities authorized under that law.

At present, federally insured lending institutions such as banks and thrifts are required to collect data on the loans they make and how those loans are allocated. Federal regulators then evaluate those data in a subjective and arbitrary manner to determine how well the financial institutions are meeting the credit needs of the neighborhoods from which they gather deposits. After all the work is done at considerable expense to the institutions that are rated and taxpayers who fund the agencies that conduct the examinations, about 98 percent of banks receive a satisfactory or better rating. (Banks receive one of four ratings: Outstanding, Satisfactory, Needs Improvement, and Substantial Non-Compliance.)

Some supporters of the CRA maintain that banks are lending in low-income neighborhoods because of the legislation. Others claim that the high percentage of banks that obtains a satisfactory rating or better is an indication that the current legislation is too lax and that it needs to be strengthened. But the fact is that there is no evidence that the CRA has had any discernible effects on lending in low-income or distressed neighborhoods, nor is there evidence that a stronger CRA would benefit low-income neighborhoods. Where profitable investment opportunities exist, banks are already lending. Where they do not, banks are not lending and should not be required to do so.

If the CRA had a real impact, we should expect financial institutions subject to its requirements to lend more aggressively in low-income communities than lending institutions that are not subject to the law. But Jeffery W. Gunther, an economist at the Federal Reserve Bank of Dallas, and others have shown the opposite to be true. Financial institutions subject to the CRA are actually lending less in low-income communities than institutions not subject to the CRA. The elimination of branching restrictions, financial innovations, the new technology that has allowed lenders to screen potential borrowers better (and thus differentiate between good and bad credit risks in the same neighborhoods), and increased competition have increased the availability of financial services to low-income communities. In this new and more competitive environment, banks are unlikely to forgo profitable lending opportunities to otherwise creditworthy borrowers—regardless of race, location, or any other noneconomic characteristic of those borrowers.

There is evidence, however, that the CRA has had at least four negative effects on the communities that it seeks to help. First, outside banks seeking mergers or an expansion of their activities will provide subsidized loans in low-income neighborhoods to avoid CRA-related problems, thus misallocating capital and driving customers away from local institutions that would have otherwise provided credit to local borrowers. Second, the CRA makes it difficult for banks to close branches in distressed areas. The unintended consequence is that other banks that might consider opening new branches in low-income neighborhoods may choose not to do so lest they be unable to close them at a future date. In the end, there is less competition in those areas and consumers suffer. Third, the CRA prevents banks from specializing in servicing specific groups because the banks do not want to be accused of discriminating against other groups. Finally, by increasing the costs to banks of doing business in distressed communities, the CRA makes banks likely to deny credit to marginal borrowers that would qualify for credit if costs were not so high. Chief among those costs is the hundreds of millions of dollars in CRA loans that community activists obtain from banks to give their approval of bank mergers and other bank expansions of activities, in an exercise that can be characterized as legalized extortion.

In the final analysis, the CRA provides few benefits to those it is meant to help, while imposing substantial compliance costs to banks and taxpayers. In addition, there is conclusive evidence that the problem that the CRA was intended to correct—lack of adequate access to credit in low-income neighborhoods—no longer exists. For those reasons, the CRA should not be reformed; it should be repealed.

Deposit Insurance Reform

The House of Representatives passed by a vote of 408 to 18 the Federal Deposit Insurance Reform Act of 2002 (H.R. 3717), a bill introduced by Rep. Spencer Bachus (R-Ala.). Among other things, that legislation would increase the coverage limit for insured deposits from the current $100,000 to $130,000, index the new limit to inflation, and adjust it every five years. It would also give the Federal Deposit Insurance Corporation greater discretion in the way it charges premiums on banks and allow it to charge premiums on banks at all times, regardless of the risk individual banks pose for the FDIC fund or of the size of the fund.

The increase in the coverage limit is the measure that has received the most attention in the press and from policymakers. Higher limits would weaken market discipline by making depositors more indifferent to the risks taken by their banks without improving the welfare of consumers (who already have many opportunities to get FDIC insurance equal to several times $100,000) or the competitive position of small banks (the strongest proponents of the increase) vis-à-vis large banks.

Both the Federal Reserve and the U.S. Treasury are vigorously opposed to the increase. Indeed, in remarks before the Senate Banking Committee in the spring of 2002, Peter Fisher, under secretary of the Treasury for domestic finance, said, ''We see no sound public policy purpose that would be served by an increase in current and future coverage limits.'' Alan Greenspan concurred with that statement, noting that ''it is unlikely that increased coverage, even by indexing, would add measurably to the stability of the banking system today.''

Sen. Richard Shelby (R-Ala.), the ranking Republican on the Senate Banking Committee, also opposes the increase to $130,000. In an interview with the *American Banker*, Shelby stated his opposition to raising the current limit by saying, ''Let's roll [that limit] back to $10,000.'' Reducing the limit makes sense for at least two reasons. First, depositors would become more vigilant about the risks taken by banks, thus increasing market discipline. That discipline would be even stronger if the limit were to apply to depositors instead of accounts or deposits. Second, depositors can already obtain risk-free U.S. Treasury bills that are equivalent to cash in terms of their liquidity. Thus the coverage limit for insured deposits should be no greater than the minimum denomination for short-term Treasury bills. Today, for instance, the minimum denomination for a four-week Treasury bill is $1,000. Any coverage amount above that represents a potential taxpayer subsidy of the risk-taking activities of banks.

From the point of view of the taxpayer, however, an increase in the coverage limit is not the most dangerous provision of the reform proposals. Giving the FDIC more discretion in the way it charges premiums on banks is the most dangerous provision, because it could very well mean that taxpayers could again be liable for any losses that occurred to the deposit insurance fund, just as they were in the 1980s when the savings-and-loan crisis cost them approximately $150 billion. All four banking regulators are unfortunately in favor of that measure.

Under the current structure, which has been in place since 1991, banks are responsible for any losses to the deposit insurance fund through a system of rapid *required* ex post premiums. If losses to the insurance fund reduce the FDIC's ratio of reserves to insured deposits below 1.25 percent, the FDIC is required to automatically increase premiums to at least 23 basis points if the 1.25 percent ratio is not achieved within one year.

Although many observers consider that system too harsh, because it imposes the highest premiums when banks are the least likely to be able to afford them, it has worked reasonably well in preserving the stability of the banking system—and the pocketbooks of taxpayers. As Loyola University banking and finance professor George Kaufman has written in a recent Cato Institute study, ''The threat of a premium increase of 23 basis points serves to encourage banks to pressure the FDIC to resolve insolvencies more quickly and efficiently'' and thus avoid regulatory forbearance or negligence.

Giving the FDIC more discretion over premium policy is undesirable because, as Kaufman says, ''The longer premiums are not increased . . . the more likely the fund is to go into deficit and the taxpayer to again become liable.'' Indeed, it is likely that discretion will lead to regulatory forbearance because regulators will be under tremendous pressure from banks and politicians alike to delay the imposition of higher premiums, if and when banks get into trouble.

Furthermore, regulators may view bank failures as a black mark on their records and thus have an incentive to delay the imposition on failed banks of sanctions or even resolution proceedings. In short, regulators have often been poor guardians of the interests of taxpayers.

For that reason, it is important to consider the benefits of private, market-based regulation of banking. Federal deposit insurance is not market priced, despite FDICIA's mandate that the FDIC set premiums according to risk, and so the moral hazard of a government guarantee of deposits remains. To encourage the use of market discipline in the bank supervisory process, Congress should consider establishing a subordinated-debt requirement, so that the holders of that debt provide the main monitoring function in the supervisory process. A subordinated-debt requirement would align the interest of subordinated-debt holders with those of the deposit insurance fund (and hence taxpayers), because they do not profit from a bank's risky investments if those investments turn out to be profitable, but they stand to lose their money if those investments are not profitable. For that reason, holders of subordinated debt would have a very strong incentive to monitor closely the activities of banks. At the same time, yields on subordinated debt provide the market's assessment of the risks taken by banks. Indeed, the interest paid on subordinated debt could serve as a market-determined risk-adjusted insurance premium.

At the very least, the current system of rapid *required* ex post premium increases to fund losses to the FDIC fund should be maintained with a reduction—not an increase—in the coverage limit, lest we compromise the safety and soundness of the U.S. banking system and revert to a system of unlimited taxpayer liability. Beyond that, Congress should consider moving toward a system of voluntary, privately funded and managed deposit insurance.

Real Bankruptcy Reform Needed Now More Than Ever

The 107th Congress passed bankruptcy reform legislation by wide margins in both the House and the Senate, just as the 106th Congress had done. This time, however, the House and Senate bills were reconciled in a conference committee to produce the Bankruptcy Abuse Prevention and Consumer Protection Act of 2002, which had the support of President Bush. Unfortunately, an abortion-related provision in the bankruptcy reform bill once again prevented Congress from enacting a much-needed reform that would curb somewhat the abuses that occur under the existing bankruptcy code, a code that makes filing for bankruptcy very attractive for many debtors, including those who can easily pay their debts.

At present, individual debtors can file for bankruptcy under Chapter 7 or Chapter 13 once every six years. Consumers who file under Chapter 13 agree to a court-approved plan for repaying their debts from future earnings over three to five years. Chapter 13 filers, however, do not have to liquidate their current assets to repay creditors.

Consumers who file under Chapter 7, on the other hand, must use all their present wealth above an exemption to repay their debts, but their postbankruptcy earnings remain untouched. The exemption includes personal items, equity in owner-occupied housing, retirement accounts, and cars. The justification for exempting those items and all future income is that it provides filers with a ''fresh start'' in life after bankruptcy.

But, because the exemption levels are usually very high or filers have few nonexempt assets, in more than 90 percent of Chapter 7 cases, there is no property to be liquidated. The result: creditors get nothing. Consequently, most consumers who file for bankruptcy do so under Chapter 7 rather than Chapter 13.

Under current law, the benefits of filing for bankruptcy greatly outweigh the costs for many households. The costs include the filing fee (usually a few hundred dollars), any attorneys' fees, the amount of debt repaid, and the tarnished reputation that comes from filing. That last item is becoming less significant, however, as the stigma associated with filing for bankruptcy continues to lessen. The benefit is the debt discharged, which, given the leniency of Chapter 7, usually is a large percentage of the total unsecured debt owed. The net financial gain, then, is the difference between the benefits and the costs—a figure that is often substantial. Indeed, Michelle White, an economist at the University of California at San Diego, estimates that about 15 percent of U.S. households could benefit from filing for bankruptcy under the current system.

From a policy perspective, a problem arises because lenders, who have a hard time distinguishing between good and poor credit risks, increase interest rates for *all* consumers to recoup the losses that they incur from unpaid loans. As more and more consumers file for bankruptcy and discharge their debts, interest rates for consumer credit increase to compensate lenders for their losses. White estimates that the average borrower pays $500 a year in extra charges to compensate lenders for those unpaid loans. Thus, to the extent that innocent consumers are paying for the sins of the guilty, the current system works against honest borrowers.

The proposed legislation would reduce the perverse incentives of the current system by introducing a means test for bankruptcy. Consumers who earn more than the median income in their state and have enough disposable income to repay, over a five-year period, at least one-quarter of their debts, or $6,000, whichever is greater, would have to file under Chapter 13. The likely effect is that more people would file under Chapter 13 or refrain altogether from filing after the legislation is implemented.

The legislation, however, would not affect individuals whose incomes are below the regional median. For that reason, the current system, with all its problems, would remain unchanged for a great number of consumers. Indeed, it is estimated that fewer than 15 percent of the people who would otherwise file under Chapter 7 would be forced to file under Chapter 13 under the reform plan. A better reform would require those whose incomes are below the median to pay a (smaller) percentage of their debts based on their ability to pay—but to pay something nonetheless.

The reform legislation also leaves many loopholes, such as the homestead exemption (albeit with tighter limits), contributions of up to 15 percent of gross income to charities, allowances of up to $1,500 per child per year for schooling, contributions to ERISA-approved retirement plans, and an exemption for all tax-free retirement accounts (with a $1 million cap for IRAs), that make it easier for filers not to pay their debts. The legislation does not put in place a minimum level of debt below which debtors should not be able to file for bankruptcy. The establishment of such a threshold would make the system more cost-effective. The 108th Congress has an opportunity to correct those shortcomings.

A bankruptcy system, no matter how stringent, will always allow some debtors to abuse it to the detriment of honest consumers. Those consumers and creditors, however, will likely welcome a reform bill that protects their property rights, enforces contracts more vigorously, and reduces the incentives some people have to cheat. The 108th Congress should put politics aside and get the job done.

Time to Privatize Fannie Mae and Freddie Mac

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), the two most important government-sponsored enterprises (GSEs), are an anomaly in today's vibrant and innovative financial markets. GSEs are created by congressional charter and combine characteristics of public and private organizations. Fannie Mae and Freddie Mac are privately owned, publicly traded corporations that have a congressional mandate to provide liquidity in the secondary markets for residential mortgages. They do so mostly by purchasing mortgages from lenders, bundling those mortgages into mortgage-backed securities (MBS), and selling those securities to investors. Since the early 1980s, but especially in the last few years, they have also started to hold directly many of the mortgages they buy and to hold MBS themselves. In the process they have become two of the most profitable and dominant companies in the United States today.

If that success were due to their ability to provide goods and services that consumers want under the same rules as other market participants but at a lower price, then there would be no public policy concerns about Fannie Mae and Freddie Mac. Unfortunately, Fannie Mae and Freddie Mac do not operate under the same rules as other market participants.

They enjoy government-granted benefits and subsidies that give them an unfair advantage over their competitors, create distortions in the allocation of capital, and pose an unnecessary risk to taxpayers.

In exchange for serving a public mission, Fannie Mae and Freddie Mac enjoy an implicit government (taxpayer) subsidy to cover their liabilities. The subsidy results from, among other things, the perception that the government stands behind the obligations of those two companies, which allows Fannie Mae and Freddie Mac to have lower costs of capital than their competitors. The Congressional Budget Office has estimated that in 2000 the implicit subsidy provided by the government amounted to $10.6 billion, of which 37 percent went directly to their shareholders, not to homebuyers. Other government benefits include a $2.25 billion line of credit from the U.S. Department of the Treasury, exemption from Securities and Exchange Commission securities registration requirements, exemption from local and state taxes, and lower capital requirements than are imposed on other financial institutions, which allows them to operate with much greater leverage and earn a higher return on capital than their competitors.

While most public and congressional attention in recent months has concentrated on the fact that the two GSEs are not subject by law to the same disclosure and registration requirements as other publicly traded companies, that criticism should not be the main focus of attention for at least two reasons. First, Fannie Mae and Freddie Mac already disclose voluntarily enough information about their financial activities and condition. Furthermore, they agreed in July 2002 to file quarterly and annual statements and proxies with the SEC (although they did not agree to register their debt and mortgage-backed securities). Second, in this case, what matters is not so much disclosure; after all, Fannie and Fred could disclose that they intend to keep all profits from a very risky investment, if that investment is successful, and to pass most losses on to taxpayers, if it is not, and that disclosure would not make them any less risky. What matters is whether Fannie Mae and Freddie Mac have capital levels that are adequate for the degree of risk they are taking and for the amount of debt they have, because, if they do not, the government will most surely step in and bail them out at a very high cost to taxpayers.

Today that does not seem to be the case, and the two GSEs have no incentive to raise their capital levels or diminish their risk profiles (nor do investors have an incentive to require those actions from them) because of the government guarantee. Fannie Mae and Freddie Mac had a total debt outstanding of $1.3 trillion at the end of 2001 and had guaranteed an additional $1.8 trillion of MBS. Capital levels stood at roughly 3.5 percent of total assets, about a third of the capital levels held by commercial banks in the United States. In addition, they have in recent years begun to hold directly the mortgages they purchase, which exposes them to interest rate risk as well as credit risk, and to enter the subprime mortgage markets, where the credit risk is much higher.

The combination of the high-risk profile of their portfolios, low capital levels, and high levels of debt makes Fannie Mae and Freddie Mac potentially very vulnerable. For that reason, and given that the secondary market for mortgages works very well, Congress should initiate steps—including revoking their federal charters, terminating their Treasury lines of credit, and the presidential appointment of five members to their board of directors—toward the full privatization of Fannie Mae and Freddie Mac.

Conclusion

Technological change and financial innovation have radically transformed the financial services marketplace in the last few years to the benefit of financial services firms and consumers alike. More important, the transformation will likely continue in the coming years and financial regulations are unlikely to be able to keep up with market developments, which could prevent an efficient and sound modernization of the U.S. financial system. Although the process of modernization will not necessarily be smooth, regulators and Congress must resist temptations to go back to the old, rigid structure that came undone with the Gramm-Leach-Bliley Act. Market forces, if allowed to do so, can be very effective in exerting the discipline necessary to minimize conflicts of interest and in correcting any shortcomings that may come along the way. Congress should continue with the elimination of the regulatory burden to which financial services firms are subject and let the shape of the financial marketplace be determined by buyers and sellers of financial services.

Suggested Readings

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Kaufman, George G. ''FDIC Reform: Don't Put Taxpayers Back at Risk.'' Cato Institute Policy Analysis no. 432, April 16, 2002, www.cato.org/pubs/pas/pa-432es.html.

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