BANKING AND CREDIT

How to promote efficiency and competition in banking while keeping banks safe for depositors

Legislating "Financial Modernization": Is the Game Worth the Candle?

By Lawrence J. White

Congress has struggled for the past two decades to pass "financial modernization" legislation that would undo the compartmentalization of commercial banks, securities firms, and insurance companies that it created in the 1930s and reinforced in the 1950s. Our legislators have not yet succeeded, but they were trying again as this article was being written. The demise of compartmentalization would be worthwhile, although the benefits are likely to be modest. But it is likely that more restrictions will be imposed on commercial banks, as is often the case, while important banking issues are neglected entirely. The net benefits of any new banking legislation may be small indeed.

Clearly, the U.S. polity takes a special interest in the financial sector, especially in commercial banks. Despite the general movement toward deregulation that began in the 1970s—which has encompassed banking as well as the airline, trucking, rail, and telecommunications industries—commercial banks remain among the most heavily regulated enterprises in the United States.

There are good and bad reasons to regulate banks. A sorting of the reasons, based on an understanding of what banks do and how they do it, can point the way to helpful legislation and, perhaps, help avert legislation that is burdensome or even harmful.

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UNDERSTANDING COMMERCIAL BANKS

At its simplest, a commercial bank accepts deposits from the public and makes loans to individuals and enterprises, as portrayed in Figure 1. The loans are the bank's assets, because the bank expects the loans to be repaid with interest. The deposits are its liabilities, because it owes those funds to its depositors. The difference between the value of its assets and the value of its liabilities is the bank's net worth or owners' equity ("capital" in banking parlance).

It is critically important for a bank to be able to distinguish between good and bad risks in making loans. Even after making a loan, the bank usually has to monitor the borrower so as to ensure repayment. Defaults by borrowers (loan losses) reduce the value of the bank's assets, thereby reducing its capital. Once a bank's capital is wiped out by loan losses, any further losses come at the expense of the depositors.

Of course, modern commercial banks are far more complex than the stylized bank of Figure 1. But the essence of any entity that is properly called a "bank" should be financial assets that consist of loans to borrowers, deposit liabilities that provide the funding for those loans, and a residual that represents the bank owners' equity in the bank. The same framework applies to other depositories: savings and loan associations (S&Ls), savings banks, and credit unions. And, with slight modifications, it applies as well to insurance companies (where the present and future claims of insureds are the companies' liabilities) and to "traditional" defined-benefit pension plans (where the present and future claims of retirees are the pension funds' liabilities).

UNDERSTANDING REGULATION

DESPITE GENERAL IMPRESSIONS, REGULATION CONSISTS OF more than just indiscriminate governmental intervention in the workings of the marketplace. There are ways of classifying regulatory interventions to illuminate how and why regulation occurs. Here is one such taxonomy:

Ideally, regulation is a remedy for a significant market failure. In reality, interested parties can easily conjure market failures in an effort to use government power for their own benefit.

- *Economic regulation* imposes direct controls on prices, profits, entry, and/or exit, including must-serve obligations. A familiar example is the former Civil Aeronautics Board's regulation of airline fares and routes from the late 1930s through the late 1970s.

- *Health-safety-environment (h-s-e) regulation* restricts the types or production processes of goods and services. A good example is the Federal Aviation Administration's regulation of airline and aircraft safety.

- *Information regulation* requires the delivery of certain types of information, often in a specified form, with certain goods and services. An example is the Department of Transportation's specification of the information that airlines must provide when they advertise sale fares.

Ideally, regulation is a remedy for a significant market failure that individual participants in the market cannot correct easily. Monopoly, externalities, or lack of information might cause such a failure. Thus, economic regulation would deal with monopoly (e.g., the regulation of local electricity prices); h-s-e regulation would deal with externalities and severe informational deficiencies (e.g., the regulation of pollutants and product safety); and information regulation would deal with informational deficiencies (e.g., specifications for product labeling).

In reality, interested parties can easily conjure market failures in an effort to use governmental power for their own benefit, at the expense of market efficiency. Regulation, therefore, often favors incumbents over entrants, encourages the inefficient over the efficient, and effects income transfers through cross-subsidies. In short, regulatory remedies can exacerbate market failures and inefficiencies rather than alleviate them.

UNDERSTANDING BANK REGULATION

SINCE THE EARLY DAYS OF THE REPUBLIC, BANKS IN THE United States have been treated differently and subjected to many more restrictions than have other enterprises. Bank chartering and regulation was largely the responsibility of the states until the 1860s. Since then the states and the federal government have shared responsibilities in ways that are often duplicative and never easy to explain. The complexity of this "dual banking system" is embodied in the many linear feet of printed federal and state laws and regulations that apply to banks.

Federal regulation of banks is shared among the Office of the Comptroller of the Currency (OCC), a part of the Department of the Treasury, and two independent agencies: the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve (the "Fed"). (Further, the Office of Thrift Supervision [OTS], in the Treasury Department, regulates savings institutions, and the independent National Credit Union Administration [NCUA] regulates credit unions.) In addition, each state has bank regulatory agencies.

The structure of bank regulation is best understood in terms of the three-part taxonomy: economic regulation, safety regulation, and information regulation. These are some of the key aspects of *economic regulation* of banks:

- Banks and their holding companies are largely restricted to activities that are closely related to banking: They are not permitted to own nonfinancial enterprises. Their insurance activities are severely

Figure 1

Stylized Balance Sheet of a Commercial Bank

ASSETS	LIABILITIES
$100 (loans)	$92 (deposits)
	$8 (net worth, owners' equity, or capital)

restricted. They can operate securities and brokerage activities only through separate subsidiaries. And their securities underwriting activities are substantially limited.

- Until the early 1980s, banks were largely restricted to single-state operations, and many states restricted banks' locations within a state. Regional compacts among the states gradually allowed banks to expand across state boundaries, and federal legislation in 1994 further loosened restrictions on banks.

Populist suspicion of financial institutions as unduly large, powerful, and monopolistic underlies the history of political antagonism toward banks and the resulting efforts to restrict them.

- Beginning in 1933, the interest rates that banks could pay on their deposits were restricted by the Fed's "Regulation Q." Legislation in the early 1980s phased out interest-rate restrictions, with an important exception: banks still are not permitted to pay interest on commercial checking accounts.

- Some states set ceilings on bank-loan interest rates and credit-card fees (e.g., late payment fees).

- Federal legislation—the Community Reinvestment Act of 1977 (CRA)—obliges banks to "meet the credit needs of the local communities in which they are chartered."

Safety regulation (usually termed safety-and-soundness regulation) encompasses broad restrictions on the activities that banks can undertake, the types of assets that they can hold, and the types of liabilities that they can issue. Each bank also must meet a minimum capital requirement, which is intended to be commensurate with the risks undertaken by the bank. Although federal agencies and state governments—represented in the field by "examiners" and "supervisors"—share enforcement, the federal government increasingly has absorbed enforcement responsibility because, ultimately, it bears the costs of bank failures through federal deposit insurance.

Key elements of *information regulation* are the fine-print disclosures that accompany credit cards, the standard information about interest rates that must be given to borrowers and depositors, and the requirement that a bank provide a copy of its balance sheet to anyone who asks for it.

WHY ARE BANKS SO HEAVILY REGULATED?

BEFORE SUGGESTING A SENSIBLE REGULATORY STRUCTURE for commercial banks, one should ask why banks are so heavily regulated. Why are they subject to far more regulation than, say, neighborhood grocery stores or shoe repair shops?

First, consider banks' assets: the loans they make. Banks historically have been important lenders to the rest of the U.S. economy. When lending was mostly a local activity, especially in the nineteenth century, the insolvency of a bank in a small community could spell credit-availability problems for local enterprises. Because of recent rapid progress in data processing and telecommunications—the two technologies that are at the heart of finance—banks today play a much smaller role in the provision of credit than they did a century ago; but memories—especially political memories—linger. Further, banks remain an important source of credit for *small businesses*. Thus, the spotlight turned immediately on banks when there were allegations of a "credit crunch" in the early 1990s.

Second, consider banks' liabilities: deposits. Bank deposits traditionally have been thought of as relatively safe and readily accessible repositories for wealth, as well as convenient vehicles for effecting payments. Bonds and stocks have been understood to carry substantial risks, but not bank deposits. The enactment of federal deposit insurance in 1933—following a century of experimentation with deposit insurance by the states and thousands of bank failures between 1929 and 1933—solidified the special status of bank deposits as a safe haven for wealth.

Third, the particular combination of longer-term and relatively illiquid assets (loans) and shorter-term and relatively liquid liabilities (deposits) poses a special problem for banks. If all depositors were to demand the withdrawal of their deposits simultaneously, even a solvent bank would be unable to meet the demand because its cash holdings would be only a small fraction of its total assets. Further, the actual value of the bank's assets may be difficult for depositors to ascertain. A bank is thus susceptible to a run by ill-informed depositors, fearing the bank's insolvency, or even by well-informed depositors, fearing that a run by other depositors will lead to the bank's insolvency.

Fourth, populist suspicion of financial institutions as unduly large, powerful, and monopolistic underlies the history of political antagonism toward banks and the resulting efforts to restrict their activities, locations, and sizes.

Fifth, the popular perception of banks as powerful surely has been fed by the fact that banks (as lenders) are among the few retail institutions that may say "no" to potential business—unlike typical retailers who almost always want to sell more to their customers. (Insurance companies, landlords, and rental agencies are the others who may say "no," for reasons similar to those of banks.) Although a "no" follows from the special nature of the loan transaction and the risk of loss, such subtleties often evade disgruntled loan applicants and their political representatives, who then loudly condemn the "power" of "the banks."

Finally, the American public's general lack of numeracy and sophistication in financial matters has bred a near mysticism about money and things related to it. That surely has fed the perception of banks as powerful entities that must be kept politically accountable—that is, regulated.

WHERE WE ARE TODAY

DESPITE THE TRADITION OF HEAVY REGULATION OF BANKing, the past two decades have seen substantial deregulation—achieved partly by legislation, partly by enlightened regulators, and partly by court decisions supporting sharp-eyed lawyers who have found loopholes in the otherwise restrictive legislation of the 1930s.

As mentioned above, legislation in the early 1980s ended most of the deposit interest-rate controls of the 1930s, and legislation in 1994 hastened the removal of many restrictions on interstate branching. Bank regulators in the 1980s and 1990s generally encouraged entry and competition, and the courts have generally supported limited extensions of banks into securities and insurance. (This otherwise sensible record of enlightened deregulation was marred when S&L regulators in the early 1980s—encouraged by Congress—dismantled crucial safety-and-soundness restraints at a time when almost all S&Ls were financially stretched and prone to unsafe risk-taking. A spree of high-risk lending and a costly debacle then followed.)

As far as it has gone, however, deregulation has left intact the formal barriers between commercial banks and securities firms, established by the Glass-Steagall Act of 1933, and the barriers between banks and insurance companies and nonfinancial activities, embodied in the Bank Holding Company Act (BHCA) of 1956.

Since the late 1970s, Congress has grappled intermittently with the dismantling of those barriers—most recently under the rubric of "financial modernization"—but various political forces successively have stalemated such efforts. The securities industry, fearing the incursion of banks onto its turf, stalled legislation for a decade. The securities industry made peace when it realized that banks already had encroached substantially through regulators' and courts' interpretations, without dismantling the Glass-Steagall Act.

The insurance industry then became the spoiler. Because securities firms could legally own insurance companies, the effective dismantling of Glass-Steagall also required the removal of the BHCA's restrictions on banks' insurance activities—a prospect that dismayed the insurance industry. In the early 1990s, the industry blocked legislation aimed at removing barriers between banking and insurance. Even after insurance companies dropped their resistance, the politically potent independent insurance agents continued to thwart enabling legislation.

In 1998, political forces seemed aligned for passage of legislation to remove the Glass-Steagall and BHCA barriers. But legislation was derailed yet again by a last-minute dispute over whether and how banks' CRA obligations should be modified—an important issue, but one that is unrelated to the issue of compartmentalization.

As Congress grinds through its 1999 session, financial modernization is prominent on its agenda. This time there are four major areas of dispute:

- The extent to which banks should be permitted to enter commercial (nonfinancial) activities, if at all
- The location in a bank's structure of any permitted non-banking activities, including securities and insurance
- The proper scope of CRA

As is usual in disputes about banking, the debates are enshrouded in much smoke and fog—the rhetoric of populism, efforts to protect regulatory turf, and images of widows and orphans.

- And (new this year) how banks ought to treat the information they collect about their customers' finances and transactions.

As is usual in disputes about banking, the debates are enshrouded in much smoke and fog—the rhetoric of populism, efforts to protect regulatory turf, and images of widows and orphans. Rarely found are concerns about economic efficiency, a proper understanding of banks and banking, and a sensible approach to bank regulation.

A SENSIBLE STRUCTURE FOR BANK REGULATION

THE THREE-PART TAXONOMY OF REGULATION DEPICTED earlier will serve us well here. Drawing on that taxonomy, I sketch a turf-free, efficiency-focused regulatory structure for banking, offer additions to the current legislation that would lead to true financial modernization, and suggest how to resolve the disputes that have clouded the current legislation.

Economic Regulation Economic regulation should be reserved for instances of major and irremediable monopoly. Even then, the history of economic distortions and abuses that often have accompanied economic regulation ought to give pause. The deregulatory efforts of the 1970s and 1980s replaced governmental restrictions on pricing, entry, and exit where competitive market structures promised—and delivered—greater economic efficiency.

The Case for Abolition Economic regulation of banking should be abolished; it is unnecessary. Despite two decades of mergers and consolidation, the United States still has more than 8,700 commercial banks—plus 1,600 savings institutions, 10,000 credit unions, about 5,000 insurance companies, about 5,000 securities firms, and untold thousands of commercial- and consumer-credit companies. Rapid improvements in data processing and telecommunications enable banks to offer their services over ever-wider geographic areas, which brings banks increasingly into competition with each other—and increasingly enables nonbank financial-service enterprises to offer bank-like products and services.

Even where banks may still be special—arguably for local deposits and lending to small and medium-size local enterprises—they will face increasing competition from other banks. The proper instrument for ensuring that mergers do not lessen or eliminate that competition is antitrust merger policy, enforced by the Department of Justice using the same standards that it applies to other industries.

The abolition of all bank-focused economic regulation would mean that—subject to the safety considerations discussed below—banks ought to be allowed to own and operate any other type of financial or nonfinancial enterprise, just as such enterprises ought to be able to own and operate banks. There would be no arbitrary barriers between banking and commerce.

The efficiency gains from such conglomerations are likely to be modest, at best. The history of experiments with "financial supermarkets" has not been encouraging (e.g., Sears' unsuccessful efforts to encompass insurance through Allstate, securities through Dean Witter, banking through Greenwood Trust, and credit cards through Discover Card). But some entrepreneurs may yet discover a successful form of financial conglomeration—last year's merger of Citicorp and the Travelers Group represents another bold experiment—and they ought to be permitted to search for it.

> **The abolition of all bank-focused economic regulation would mean that—subject to safety considerations—banks ought to be allowed to own and operate any other type of enterprise.**

The abolition of economic regulation also would mean eliminating the vestige of Regulation Q that prohibits paying interest on commercial checking deposits (an action on no one's agenda, unfortunately)—and eliminating states' usury limits and credit-card fee limits, as well.

What about CRA? CRA requires banks (and savings institutions) to "meet the credit needs" of their local communities. The requirement was imposed in 1977 when Congress believed that many banks were "redlining" (arbitrarily refusing to lend in) low-income communities. CRA has become important for banks in the 1990s because a criterion for regulatory approval of bank mergers is whether the merging banks are meeting their CRA obligations. Community activists have taken advantage of pending mergers to extract promises of more local lending from the merging banks. The pending merger between Fleet Financial and BankBoston is providing yet another opening for activists.

CRA is a manifestation of the perception that banks are powerful entities that exercise vast and arbitrary discretion. In reality, however, either the CRA obligations are redundant (because local business is profitable, anyway) or they impose cross-subsidies (banks' other activities are expected to yield enough profits to cover the losses on the local activities that banks otherwise would forgo). But cross-subsidies are untenable in the increasingly competitive financial-services markets. A binding CRA requirement is either an invitation to cynical evasion of regulation or a recipe for lending losses. (Although the language of CRA says that requisite actions by banks should be "consistent with safe and sound operation of such institutions," the dominant theme of CRA enthusiasts is that banks are "rich" and "powerful" and can afford almost anything.)

Further, it is now well understood that barriers to exit are barriers to entry: banks will be reluctant to enter and begin providing services to communities if thereby they are locked into rigid obligations. CRA's forced localism in a world of increasingly broad financial markets is anachronistic and ultimately self-defeating.

If there is a public purpose to be served by providing financial services to communities that banks (or other lenders) do not willingly provide, that argument should be made separately and, if it wins the day, public moneys should be used to support such services. Further, to the extent that the real problem is one of unacceptable discrimination in lending, based on race or other nonfinancial criteria, the appropriate remedy lies in the Equal Opportunity Credit Act of 1975, which applies to all lenders and not just to banks and savings institutions.

Safety Regulation The safe and sound operation of banks is a legitimate public concern and thus suitable for regulation. At the core of the popular focus on banks is a legitimate concern for the safety of banks' liquid liabilities (deposits) and the potential dangers faced by institutions that have liquid liabilities and illiquid assets (loans). Safety regulation therefore limits banks' risk-taking activities and sets capital requirements for banks.

Limits on Banks' Activities Embedded in the debate surrounding financial modernization and the expansion of banks' activities has been some concern about the effects of expansion on banks' safety. But almost all of the discussion starts in the wrong place (populism, fears of bigness) and fails to ask the right questions:

- For which activities can bank examiners and supervisors establish appropriate risk-related capital requirements and risk-related deposit insurance premiums?

- Can examiners and supervisors recognize when banks are performing those activities competently?

Only those activities that are examinable and supervisable should be permitted within a commercial bank.

Regulatory agencies, not Congress, should determine which activities are examinable and supervisable. The agencies not only have the better view of banks' activities but they can be more flexible and adjust more quickly to experience. Regulatory agencies' leaders should, of course, be held accountable for their agencies' decisions, but Congress should not micromanage the agencies unless there is evidence of gross dereliction.

Are securities activities or insurance activities examinable and supervisable? The answer ought to be provided by the regulators, and not by Congress.

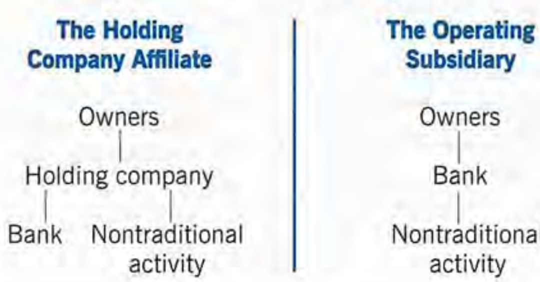
Any activities that are deemed not examinable and supervisable, and are thus inappropriate for a bank, should be permissible anywhere else in the larger organization in which the bank is embedded—as long as the bank's dealings with (e.g., loans to, purchases from) affiliated entities are at arm's length. Otherwise, transactions with affiliated entities would afford an easy opportunity for the bank's owners to siphon assets out of the bank.

Out-of-bank activities could reside either in a separate subsidiary of the holding company or in an operating subsidiary (op-sub) of the bank itself. Figure 2 portrays these two possibilities. The Fed favors the former arrangement; OCC (and Treasury) favors the latter one. Their positions happen to coincide with their respective regulatory responsibilities.

Either arrangement can protect a bank from direct harm if an out-of-bank subsidiary incurs losses or fails, as long as the net worth of an op-sub or holding company subsidiary does not count as an asset of the bank. But gains that accrue to an op-sub must pass through the bank before they reach the ultimate owners and thus can support the bank in times of need, whereas the holding company arrangement does not provide such direct support to the bank. Moreover, because an op-sub's assets must travel through the bank to get to the bank's owners, it is harder to strip assets out of an op-sub (e.g., through loans) than to strip assets out of a holding company subsidiary. Finally, the op-sub arrangement fosters greater organizational efficiency. In sum, the op-sub route is the way to go.

Figure 2

Potential Locations for Activities That Are Not Examinable or Supervisable



Capital Requirements With respect to capital requirements, over the past decade bank regulators have come to understand increasingly well that (1) capital is the buffer that protects depositors (and the deposit insurance fund) and (2) capital should be at a level commensurate with the risks undertaken by the bank. Although risk-adjusted capital requirements still are not sufficiently sensitive to measures of credit (borrower default) risk, interest rate risk, or general market risk—and are not yet sufficiently forward-looking—regulators are moving in the right direction.

There is, however, a gaping hole in the regulatory treatment of capital levels. As Figure 1 reminds us, capital is simply the difference between the value of a bank's assets and the value of its liabilities. The method of measuring those values is thus crucial in determining whether a bank has adequate capital. The sensible method of measurement, from a safety-and-soundness perspective, is to rely on the *market values* of the bank's assets and liabilities. Unfortunately, bank regulators use the accounting framework that is applied to publicly traded companies—generally accepted accounting principles (GAAP)—despite GAAP's focus on historical costs (book values) rather than current market values.

The time is right for bank regulators to adopt *market-value accounting*. The banking industry is enjoying relatively high capital levels (as measured by GAAP), and the market values of almost all assets are probably at or above their book values. Most banks would suffer little immediate pain in a transition to market-value accounting. Alas, such a change is not on anyone's agenda.

Finally, as another way of engaging the market, regulators should require banks to meet their capital requirements by issuing at least a certain amount of long-term subordinated debt. Such nondeposit liabilities would absorb losses before they are passed on to depositors or the deposit insurer. (In terms of Figure 1, subordinated debt would occupy a middle place between a bank's deposit liabilities and its net worth on the right hand side of the balance sheet.)

Subordinated debt likely would be bought by sophisticated investors whose interests would serve regulators' interests in preserving banks' safety and soundness. Such investors would become an additional source of restraint on banks' managers because the investors would be the first in line to absorb any losses after excessive risk-taking has wiped out owners' equity.

Again, with bank capital at relatively high levels, the time is right to require banks to issue a minimum amount of subordinated debt. And again, unfortunately, such a change is not on anyone's agenda.

Information Regulation The issue of how and whether sensitive financial and transaction information about banks' customers should be transferred among affiliates or sold to third parties is akin to a consumer-safety issue. That is, customers might well ask if it is safe to entrust confidential information to this or that bank.

Ideally, banks would be sensitive to customers' concerns and would announce policies for handling confidential information. And customers would take into account those announced policies in choosing banks. If a bank did not announce a policy, its customers could assume the worst about the bank's use of confidential information and behave accordingly.

In reality, many customers would not notice the absence of a policy, but they would nevertheless feel that a confidence had been violated if their information was sold to third parties. Many such breaches of implicit trust probably would call forth a heavy-handed political response. The problem might be avoided in the first place by imposing simple regulatory requirements, in the spirit of information regulation:

- Banks must establish and announce policies for handling customer information (even if a policy is to have "no policy").

- And banks must clearly and systematically communicate those policies to their customers.

CONCLUSION

ALTHOUGH THE BASIC FEATURES OF BANKS ARE SIMPLE, there is rarely anything simple about bank regulation. Populism and fears of large financial institutions have led to a complex and multi-faceted regulatory system that imposes inefficiencies on banks when it ought to be focused on their safety and soundness.

Congress's long and thus far unsuccessful struggle to enact "financial modernization" legislation is a testament to the political milieu surrounding bank regulation. Even if Congress finally were to succeed in passing some form of legislation, it seems likely to fall short of what is needed to promote a modern, efficient, and stable financial system.

A Congress that is truly interested in financial modernization would erase all compartmental boundaries within the financial sector and between the financial sector and the rest of the economy. Such a Congress would focus almost entirely on improving safety-and-soundness regulation: mandating market-value accounting and the issuance of subordinated debt, and permitting any activities that are not examinable or supervisable to be located in the operating subsidiaries of banks. That game definitely would be worth the candle.

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