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THE DEPOSITORY INSTITUTIONS ACT OF 1988: REPLACING HANDCUFFS WITH LEG IRONS

(Updating *Issue Bulletin* No. 140, "The Senate's New Banking Bill: A Timid Reform," April 27, 1987.)

The United States Senate this March passed the Financial Modernization Act of 1988 (S. 1886), sponsored by William Proxmire, the Wisconsin Democrat. The bill would dismantle much of the Glass-Steagall Act, the 1933 law that rigidly separates commercial and investment banking in America. The Proxmire bill would allow bank holding companies to offer, through affiliates, most investment banking services, including access to mutual funds and corporate bonds. Though banks would not be permitted to underwrite corporate equity, Congress would reconsider this issue in April 1991. The Proxmire bill imposes some restrictions on new bank activities. For instance, the bill would limit loans and other financial connections between banks and their securities affiliates, as well as prohibit most banks from selling insurance. In addition, bank holding companies with more than $30 billion in assets would not be allowed to merge with investment banks with assets greater than $15 billion.

The Financial Modernization Act improves existing law, although it fails to provide the full scope of reform that is badly needed. Soon the House Energy and Commerce Committee will consider banking legislation. H.R. 5094 already has been reported by the House Banking Committee. The legislation ultimately will be considered by the full House and, if passed, reconciled in conference with the Senate bill.

Costly Price. While the Proxmire bill would be a small step forward, its House counterpart in its expected form would be a giant step backward. Sponsored by House Banking Committee Chairman Fernand St. Germain, the Rhode Island Democrat, and approved by the committee this July, the "Depository Institutions Act of 1988" would, like the Senate bill, relax Glass-Steagall — but at the price of requiring banks to perform so many costly services for non-depositors that the *Wall Street Journal* predicts that the bill would transform banks into "quasi-welfare agencies."

That the Glass-Steagall Act needs drastic revision or repeal now is acknowledged by most economists. The legislation, spawned during the Great Depression, when the U.S. financial system was in chaos and banking technology was in its infancy, is outmoded today. While the rest of the financial community and foreign banks take advantage of advances in information processing and the financial innovations it affords, America's commercial banks labor under a law reflecting conditions half a century ago. The economic case for repealing Glass-Steagall thus

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is overwhelming. Permitting banks to underwrite corporate equity and debt would reduce the cost of capital for American business and enable U.S. banks to compete head-to-head with the foreign banks that recently have come to dominate international finance. Allowing banks to offer insurance underwriting and real estate services also would offer the U.S. consumer wider services at lower prices.

Burdening Smaller Banks. H.R. 5094 would amend the Glass-Steagall Act to permit well capitalized banks in the Federal Reserve System to affiliate, through a bank holding company, with firms underwriting or selling securities. The trouble is that banks and their securities affiliates would not be allowed to market services jointly or use the same name or logo. Making matters worse, H.R. 5094 is encumbered with so-called consumer provisions that will place a massive new burden on the banking system, particularly smaller banks. Among these: mandatory government check cashing for non-customers and stiffer enforcement of the Community Reinvestment Act of 1977.

Each of these provisions will hurt most bank customers. Mandatory government check cashing forces customers with bank accounts to cover the potential cost of fraud by non-depositors. Significantly, the National Bankers Association, which represents minority-owned financial institutions, opposes any government check-cashing provision for non-customers because its experience indicates that "the fraud and operational cost of such a practice would be ruinous [to member banks]." Even more troubling is the stiffening of requirements under the Community Reinvestment Act of 1977 (CRA). The purpose of this act is to require depository institutions to provide services to poorer communities. Under the act, banks are rated on a scale of one to five on the basis of their actions in the community; one is considered excellent. H.R. 5094 would link the freedom a bank has to expand its financial services to its CRA rating. Ironically, the effect of tightening the CRA requirements would be to discourage banks from establishing branches in low-income communities.

Setting the Stage for an Overhaul. Although there is general agreement that America's banking laws are in need of urgent reform, the case for these and other consumer "protections" is by no means clear. Thus the House should concentrate on passing a "clean" financial deregulation bill, granting banks the right to sell securities, insurance, and real estate. These latter two activities are particularly important for smaller banks and their customers in small towns. Restrictions on joint advertising and the use of a common name, logo, and premises by a bank and its securities affiliate, moreover, make no sense.

American banks have been handcuffed by Glass-Steagall for more than a half-century. H.R. 5094, the Depository Institutions Act, merely replaces these handcuffs with leg irons. With Senate passage of a progressive, albeit limited, banking deregulation bill, the House Energy and Commerce Committee now has the opportunity to provide a compatible bill and set the stage for a long overdue major overhaul of U.S. banking.

John E. Buttarazzi
Policy Analyst