

The Thomas A. Roe Institute for Economic Policy Studies

February 26, 1991

HOW TO REFORM AMERICA'S BANKING SYSTEM

INTRODUCTION

America's system of banking and financial services institutions is in need of a fundamental overhaul. The spate of banking failures in recent years could mean insolvency for the Federal Deposit Insurance Corporation (FDIC), the federal agency that insures deposits held in most banks. The FDIC has been losing money for the last three years and could run short of reserves to cover claims as early as next year. Congress then might feel compelled to prop up the FDIC — at a cost of hundreds of billions of dollars — to head off a banking collapse.

Yet the FDIC itself, by providing insurance for the same premium cost to depositors in prudent and reckless banks alike, has encouraged risky loan policies by banks and so has endangered the banking system. Moreover, various rules and statutes further jeopardize stability in the system by preventing banks from spreading business risks through diversification and by establishing branches in different states. What is needed, therefore, is a major reform of laws governing the commercial banking system, to remove those regulations and policies that weaken the system.

Targetting the Problem. The Bush Administration on February 5th released its long-awaited report examining the causes of the federal deposit insurance crisis and offering recommendations for dealing with it. The report was conducted by the Treasury. The report, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks*, correctly targets the federal deposit insurance system as a major contributor to the problem. It points out that there is little incentive for bank customers to be concerned about the soundness of their banks when their deposits are fully insured. Moreover, notes the Treasury, banks pay premiums that are unrelated to the risk associated with their lending policies. This means banks do not face higher insurance costs if they tend to engage in risky lending practices, and so

they have a strong incentive to make riskier but potentially more profitable loans.

Despite this recognition of the principal problems with federal deposit insurance, however, the Treasury suggests only a token roll-back in coverage, by limiting protection for depositors to two \$100,000 accounts per institution. Depositors still would be permitted to have insured accounts with as many separate institutions as they wish, as long as they did not use a broker to place the accounts. Moreover, the Administration recommends basing deposit insurance premiums on capital, which is very different from urging true risk-based pricing.

Hidden Tax. The report also ignores another major cause of the system's weakness — the huge hidden tax implicit in the requirement that all banks keep a portion of their funds on deposit with the Federal Reserve System (the Fed). This tax reduces bank profitability. The Fed uses these funds to buy government bonds on which it earns interest. But since the Fed does not pay interest to the banks whose money it uses, these mandatory interest-free loans to the Fed amount to a special tax levied on banks. The Treasury report could have proposed removing this burden on banks by eliminating the rule that banks keep these deposits with the Fed or by requiring the Fed to pay interest on the deposits. Instead, the Treasury report does not even address this issue.

The report does draw proper attention to various federal and state laws that restrict banks from operating across state lines. These restrictions prevent banks from spreading the risk of doing business, often making the soundness of a bank contingent on the condition of the local economy. If banks could take deposits and make loans nationwide, they would not be as vulnerable as they are to economic downturns in the local or regional economy. Canada, which allows nationwide branch banking, suffered not a single bank failure during the Depression of the 1930s. In the U.S., which does not, there were over 9,000 failures. The Administration wisely calls for the elimination of most geographic restrictions on banks, making way for full-fledged interstate banking.

Barrier to Diversification. Federal and state laws also limit the services banks can offer and the kinds of investments they can make. These laws severely impair the ability of banks to manage and reduce risk by diversifying their investments. Notes former Citicorp chairman Walter Wriston, these laws force banks “not only to put all their eggs in one basket, but to fill the basket with the same kind of eggs.”¹ The principal law blocking such diversification is the Glass-Steagall Act, passed by Congress in 1933. This law created an artificial legal barrier between commercial banks, which take deposits and make loans to individuals and businesses, and investment banks,

1 Walter Wriston, “No Wonder Banks Fail,” *The Wall Street Journal*, December 19, 1990, p. A16.

which help businesses raise money by selling stock or bonds to the public. To its credit, the Administration proposes that the law be amended to allow commercial banks to offer securities, mutual funds, and insurance. The Administration, however, stopped short of calling for outright repeal of the Glass-Steagall Act. Rather, it proposes limiting the right to offer new services to banks that already are in a strong financial position. Thus the Administration's approach would restrict diversification and risk reduction by the very banks that most need them.

The Bush Administration proposals for banking reform do take modest steps in the right direction. But because the Treasury report does not recommend such steps as the introduction of genuine risk-based deposit insurance premiums, it fails to address the perverse insurance incentives for banks to engage in risky loans. Lawmakers should remember it was a similar failure to base federal insurance premiums for savings and loan institutions on the risk of their investment portfolios that triggered the overexposure and collapse of that industry. If Congress does not enact more sweeping reforms of the FDIC than called for by the Administration, a similar tidal wave could engulf America's banks.

THE NATURE OF THE DEPOSIT INSURANCE PROBLEM

Federal deposit insurance was created in response to a huge number of bank runs and failures in the early years of the Great Depression. Between 1929 and 1933, the number of banks in the U.S. dropped from approximately 25,000 to about 14,000, a fall of nearly 40 percent.² Congress responded by passing the Bank Act of 1933. Among other things, this created the Federal Deposit Insurance Corporation (FDIC). Though intended in part to compensate small depositors who lost their savings as a result of bank failure, the main aim of federal deposit insurance was to prevent runs on banks by reassuring depositors that their money was safe. At least initially, participation in the FDIC was voluntary. Although all federally-chartered banks, and all state-chartered banks choosing to be members of the Federal Reserve System, were required to purchase insurance from the FDIC, state banks that chose not to be part of the Federal Reserve System were free to decline FDIC coverage, as long as their state allowed them to do so. Many states did not require the banks they chartered to be insured by the FDIC, and federally-chartered banks — normally called national banks — that did not want FDIC coverage were free to re-charter themselves as state banks. However, virtually all banks, whether state or national, today are required to purchase coverage from the FDIC.

² George G. Kaufman, "The Truth about Bank Runs," in Catherine England and Thomas Huertas, eds., *The Financial Services Revolution: Policy Directions for the Future* (Boston: Kluwer Academic Publishers for the Cato Institute, 1988), p. 16.

Through 1989, the FDIC maintained reserves to cover bank failures by charging banks offering FDIC coverage for depositors a premium of 8.3 cents per year per \$100 of deposits. Congress permitted the FDIC to raise deposit insurance rates to 12 cents at the beginning of 1990, and to 19.5 cents at the beginning of this year. Late last year Congress also removed all constraints on the FDIC's authority to raise deposit insurance rates in the future, and premiums could increase significantly. FDIC Chairman L. William Seidman has indicated that he may soon raise the rate from 19.5 cents to 23 cents per \$100 of deposits.

FDIC Protection. Officially, the FDIC insures deposits only up to some maximum amount, currently \$100,000. The law, however, allows individuals to hold multiple accounts with multiple institutions. Thus, an individual with \$500,000 need only divide it into five equal parts and deposit the money in five different bank accounts for it to be fully insured.³ Further, although it has no legal obligation to do so, the FDIC routinely chooses to pay all depositors in full, even those with balances exceeding \$100,000 — although this is by no means automatic.⁴ In addition, the FDIC in practice maintains a “too big to fail” policy. This means that in the case of most larger failing banks, deemed vital to the stability of the regional or national banking system, the FDIC will arrange for another institution to acquire the bank and assume its liabilities. In some instances, the FDIC even provides direct financial assistance to the troubled bank to keep it in business.⁵ As a result, even very large depositors effectively have all their money protected by the FDIC.

While federal deposit insurance worked reasonably well for decades, the system is now in turmoil. The number of bank failures has risen sharply in recent years, with over 100 banks failing in 1985, 1986, and 1990, and over 200 failing in 1987, 1988, and 1989. Because of the sharp increase in bank failures, the FDIC barely broke even in 1987 and has lost money every subsequent year. By the FDIC's own estimate, the Bank Insurance Fund will have been depleted from a peak level of \$18.3 billion in 1987 to only \$2.4 billion by the end of 1992. Under the FDIC's alternative “pessimistic” forecast, the Fund will be completely out of money by the end of this year.⁶

The design of federal deposit insurance is in large part to blame for the current crisis. The central design flaw is that the FDIC makes no attempt to estimate the relative riskiness of the institutions it insures. By contrast, private insurers of all kinds assess the risk involved in each policy they write and vary

3 Americans can obtain insurance coverage for multiple accounts with a single institution as long as each account is of a different type or is in the name of a different family member.

4 For example, the FDIC decided recently not to cover uninsured deposits at the Freedom National Bank of Harlem, New York City.

5 For example, the FDIC did this in 1984 to prevent the failure of Continental Illinois National Bank and Trust Company in Chicago.

6 Federal Deposit Insurance Corporation, “Overview of the Bank Insurance Fund,” January 31, 1991.

the price of the insurance accordingly. For example, auto insurance companies look at an individual's accident history and other characteristics, and charge more to drivers who are greater accident risks. The FDIC, however, charges the same rate to all commercial banks.

Because deposits are insured without regard to the risk inherent in a bank's lending portfolio management policies, and in practice are insured beyond the official \$100,000 limit, depositors have little or no incentive to consider the soundness of these policies before deciding where to place their money. By contrast, if deposits were not effectively insured without limit, depositors with very large accounts would have an incentive to choose a bank more carefully.

Subsidizing Risky Investments. Similarly, basing insurance premiums on an assessment of bank lending practices would curb excessive risk-taking. The reason for this is that insurance rates would influence bank lending behavior. A bank makes money principally by taking deposits, on which it pays interest, and then lending that money out at a higher rate of interest. Other things being equal, the higher the interest rate a bank receives on its loans, the more profit it will make. All banks charge more for loans they believe are riskier, since there is a greater chance that some of these loans will not be repaid. Normally the higher rate of return on riskier loans that are repaid makes up for losses on those that are not. But if a bank is inclined to make a disproportionate number of risky loans, in an effort to boost profits, depositors face a correspondingly greater risk of losing their money in a failure of the bank. Without deposit insurance, the bank either would have to pay its depositors a higher rate of interest to compensate for the extra risk to their money or it would have to pay its insurer a higher premium to reflect its riskier loan portfolio. In either case the bank would have to consider the additional costs associated with its aggressive lending policy. But when deposits are insured at a flat-rate premium, banks with riskier investments do not face higher insurance or deposit interest costs.⁷ Thus, because the FDIC charges the same premium for all banks, regardless of how risky their asset portfolios are, federal deposit insurance subsidizes risk-taking.

Charging banks the same price for deposit insurance, in effect, taxes strong and prudent institutions to subsidize the weak and imprudent. And with the failure of more and more banks in recent years, thanks in large part to the perverse incentives of the FDIC system, the government must keep raising the price it charges to all banks to cover the growing losses of the insurance fund. While this perverse incentive was present at the inception of the federal deposit insurance system, it was exacerbated each time the ceiling on deposit

⁷ Even so, higher-risk banks do pay higher rates once the public begins to believe the banks are in danger of being closed.

insurance coverage was raised. In 1975, that ceiling was raised from \$20,000 per deposit to \$40,000, and in 1980 from \$40,000 to \$100,000.

SOLVING THE DEPOSIT INSURANCE PROBLEM

To eliminate the perverse incentive for banks to engage in excessively risky lending, deposit insurance premiums should reflect the soundness of banks and the riskiness of their loans. Yet even if the government wished to introduce such a premium policy, its ability to do so is limited. The risk-assessment criteria inevitably would be subject to political pressures. In part to guard against charges of favoritism, regulators likely would resort to rigid formulas for measuring risk, emphasizing quantitative data while ignoring many relevant but intangible factors, such as the diversification and quality of loans and of management. Moreover, whereas private insurers in a competitive market improve their risk assessment practices by reacting to their competitors, as a monopoly provider the FDIC does not have the benefit of price and risk information generated by competitive markets. Thus its ability to develop good risk assessment policies necessarily is limited.⁸

The ideal solution to the problem of setting deposit insurance premiums would be to privatize deposit insurance and abolish the FDIC. The competitive private sector would do a more efficient job of guaranteeing deposits and evaluating the riskiness of banks. Such an approach, however, would be politically difficult, if not impossible, in the current political climate. This is due in large part to widely publicized failures of so-called "private" state deposit insurance funds in the 1980s in such states as Maryland and Ohio, and most recently, in Rhode Island at the beginning of this year.⁹ In fact, these funds are state-sponsored and heavily state-regulated, and thus are unable to act like true private insurers. In particular, they lack the ability to spread their insurance risk beyond the state's boundaries, so they are highly susceptible to failure if the local economy deteriorates.

If privatization of deposit insurance is not possible, other steps should be taken to encourage depositors to be more concerned about the lending prac-

8 Gerald P. O'Driscoll, Jr., "Deposit Insurance in Theory and Practice," in England and Huertas, *op. cit.*, p. 167.

9 See James L. Gattuso, "The Ohio Banking Crisis: Who's to Blame?," Heritage Foundation *Executive Memorandum* No. 77, March 22, 1985; A. James Meigs and John C. Goodman, "Federal Deposit Insurance: The Case for Radical Reform" National Center for Policy Analysis *Policy Report* No. 155, December 1990, pp. 18-19. The Rhode Island fund insured credit unions rather than commercial banks.

tices of banks, and to base insurance premiums also on those practices. Among the most important:

1) Base federal deposit insurance premiums on risk.

To the greatest extent possible, the FDIC should charge according to risk. The FDIC could, for example, retain a private firm that rates bonds, such as Moody's or Standard and Poors, to rate bank loan portfolios. Or it might require each insured bank to issue bonds which would be paid off first, before shareholders but after depositors, in the event of the bank's failure. By monitoring the price at which such bonds trade in the market, which would reflect the market's view of the bank's inherent soundness, the FDIC could assess the potential for failure.¹⁰

2) Base deposit insurance premiums also on insured balances only.

Commercial banks insured by the FDIC currently pay a premium based on their total deposits, including those above \$100,000, even though officially each deposit is insured only up to \$100,000. While this practice may make some sense given that the FDIC provides *de facto* coverage even on balances above \$100,000, it makes deposit insurance premiums much more like a tax on bank deposits than a fee paid for a service provided. If deposit insurance coverage were limited, as it should be, then deposit insurance premiums should be based only on insured balances.

3) Limit deposit insurance coverage.

The "too big to fail" policy should be abandoned. The FDIC should not waste resources propping up unsound banks, no matter how large they are. Though some might object that the FDIC cannot afford to let certain larger and especially important banks fail, for fear that their failure might start some sort of chain reaction of failures by other banks, this argument makes sense only in a world in which banks are kept artificially small and failure-prone by restrictions on their branch locations and their business activities. If banks were allowed to branch nationwide, they would in reality be too large and too diversified to fail, and so a special policy to prop them up would not be necessary. Further, the \$100,000 upper limit on insured accounts should be strictly enforced, and the limit should apply to each person, rather than to

¹⁰ The price of the bank's stock does not perform the same risk-assessment function because stockholders, unlike bondholders, stand to benefit if risky investments pay off. This is because bonds pay a fixed rate of interest no matter how much profit the bank makes. For bondholders, therefore, risky investments are a lose-or-break-even proposition. Their interests and those of the depositors coincide much more closely, making bondholders' market valuations a better guide to the FDIC.

each account, so that individuals can no longer have all of their deposits insured by the FDIC simply by holding multiple accounts.

The upper limit on coverage for deposits gradually should be reduced, perhaps to \$40,000, and the government also should consider covering less than 100 percent of those deposits it does insure — say, 80 cents on the dollar on balances above a certain level.¹¹ Limited FDIC coverage would make supplementary private deposit insurance possible. This would be a major improvement because privately-provided insurance would be priced on the basis of risk.

4) Phase in reforms gradually.

To avoid the danger of a run on the banking system in response to deposit insurance reform, three precautions should be taken. First, banks and the public should be given plenty of advance warning before any reduction in federal deposit insurance coverage. Second, any phasing-out of federal deposit insurance coverage should be done gradually. And third, and most important, banks should be given broader powers to diversify before any substantial reduction in federal deposit insurance coverage becomes effective. If federal deposit insurance were reduced while bank powers remained unchanged, nervous depositors who wanted the security of having their deposits fully protected by the United States government likely would switch their money into alternatives to bank accounts, such as money market mutual funds that invest in U.S. Treasury securities. Since current law prevents commercial banks from providing such alternative accounts, there could be a huge flow of funds out of the banking system. To avoid this danger, banks should first be given broader powers to diversify — including at the very least the power to offer mutual funds on the same basis as non-bank mutual fund companies. This would mean that mutual fund balances would have to be made exempt from the special restrictions, such as reserve requirements, to which banks are subject.

¹¹As recently as 1980, \$40,000 was deemed quite sufficient coverage and only \$35,000 would be needed to provide the equivalent today of the \$5,000 of coverage that was provided in 1934. See Melanie S. Tammen, "The Savings and Loan Crisis: Which Train Derailed — Deregulation on Deposit Insurance?" *The Journal of Law & Politics*, Volume VI, No. 2 (Winter 1990), pp. 316, 318.

The Administration Position

The Treasury report recognizes the problems associated with the current deposit insurance system, and the need for reform. Yet the Treasury suggests only a token rollback in coverage, limiting a depositor's coverage to two \$100,000 accounts per institution. The Administration thus still would allow depositors to maintain insured accounts with many separate institutions as long as they did not use a broker to place their accounts.¹²

The Administration's proposal also would base FDIC premiums on the level of capital of a bank. The capital of a bank is the amount of funds provided by shares and similar owner equity — rather than by depositors.¹³ The higher this amount, known as capitalization, the lower the premium compared with other banks with similar levels of deposits. The assumption is that the more capital a bank has, the greater the incentive to exercise prudence, since more of the owners' money is at stake. Yet the level of capital appropriate to any particular bank depends on many factors. On the one hand, a prevalence of risky investments certainly should lead a bank to maintain a higher level of capital to protect depositors and the FDIC. On the other hand, a low level of capitalization is quite justifiable if a bank is very conservative in its lending practices, and thus very sound. Thus, while the Administration's proposed reform would encourage more aggressive banks to maintain higher levels of capitalization, it would have the perverse effect of penalizing careful, risk-averse banks. These latter banks either would suffer reduced profits, because of higher FDIC premiums or because they would be forced to overcapitalize given the low risk of their loan portfolio, or they would be encouraged to seek higher returns from more risky loans. Thus, although the Administration proposal would be an improvement on the current practice of charging a flat-rate insurance fee based on deposits, it should not be confused with true risk-based pricing.

12 Wealthy individuals seeking to obtain more than \$100,000 of FDIC coverage have in the past simply opened accounts with more than one institution. Depositors seeking to open multiple accounts in widely dispersed banks often do so through a broker who specializes in opening such accounts on behalf of customers. The Administration's proposals would continue to allow this practice but henceforth would cease to provide FDIC coverage for any such brokered accounts created after the proposals took effect.

13 As defined under current regulations, the term "capital" also includes certain kinds of debt that normally would be classified as liabilities rather than equity but which are classified as part of a bank's capital for purposes of the regulations.

RESERVE REQUIREMENTS: THE HIDDEN TAX ON BANKS

Another major factor contributing to the problems facing America's banks is a hidden tax that reduces the profitability of the banking industry and encourages banks to make riskier loans. There are, in fact, many such taxes, including minimum capital requirements and the cost of complying with voluminous government-mandated paperwork requirements. But the most significant hidden tax arises from reserve requirements.

To limit credit creation and control the supply of money in the country, the federal government requires all banks and other depository institutions to keep a certain portion of their assets on deposit with the Federal Reserve System.¹⁴ The amount required is a certain percentage of a bank's deposits.¹⁵ The Fed in turn invests these funds, mainly by purchasing bonds issued by the federal government. Although the Fed receives interest on the securities it holds, it does not pay interest on the bank funds it uses to buy them. These bank reserve balances thus constitute mandatory interest-free loans to the Fed. In effect, this loss of interest is a tax levied on banks.

Tax on Stockholders, Customers. Reserve requirements constitute a tax not on bank profits but on deposits. If two banks have equal deposits but one is more profitable than the other, they still pay the same implicit tax. Thus, the precise activity penalized by the tax is not the earning of profits but the taking of deposits, and only certain kinds of deposits at that. To the extent

14 The institutions covered by reserve requirements include savings and loan associations and credit unions, as well as banks. The country is divided into 12 Federal Reserve Districts. Each bank keeps its required deposits with the Federal Reserve Bank of the district in which it is located. Since 1959, banks have been permitted to count cash in their vaults, in addition to deposits with the Fed, toward meeting their reserve requirements.

15 Banks are required only to keep reserves against their "demand deposits" (that is, checking accounts) and other "transaction account" balances. The required percentage is normally 12 percent, depending on the amount of deposits. Until late December of last year, banks also were required to set aside 3 percent of their total savings account and other "time deposit" balances, as well as their Eurocurrency balances.

that banks can raise loanable funds by other means, such as by selling bonds, they can escape the tax while still earning profits. Ultimately this tax is borne by bank stockholders, in the form of lower dividends, and by bank customers in the form of lower interest rates paid on deposits, higher interest rates charged on loans, or reduced services.¹⁶

The size of this tax and its attendant drag on American bank performance is considerable. In 1990, the reserve requirement tax on commercial banks was an estimated \$3.9 billion. Even if the December 27, 1990, reduction in reserve requirements had been in effect throughout 1990, the implicit tax on commercial banks would have been an estimated \$3.1 billion.¹⁷ This is a substantial amount, especially when compared with the commercial banking industry's total profits, which were less than \$16 billion after taxes in 1989 and which are estimated at about \$18 billion for 1990.

Discouraging Investment. This tax weakens the banking industry. Since it reduces the return on investment in the banking industry, it discourages investment capital from flowing into the industry. Because banks have to compete with other financial industries that are not subject to the special tax, such as money market mutual funds, and with investment opportunities in other sectors of the economy also not subject to the tax, banks have to make riskier, higher-yield loans to compensate for the tax and still provide competitive rates of return to depositors and investors.¹⁸

16 See Victor A. Canto, "Behind the 1991 Outlook: How Economic Policy Affects Secular Changes," (La Jolla, CA: A.B. Laffer, V.A. Canto and Associates, February 1, 1991, pp. 7, 10-11; Yolanda K. Henderson, "The Taxation of Banks: Particular Privileges or Objectionable Burdens?" *New England Economic Review*, May/June 1987, pp. 3-18; David I. Fand and Bruce Bartlett, "Reagan's Tax Revolution: Mixed Benefits for Financial Institutions," *Heritage Foundation Issue Bulletin* No. 120, September 4, 1985, pp. 2-3; G.J. Santoni, "The Monetary Control Act, Reserve Taxes and the Stock Prices of Commercial Banks," *Federal Reserve Bank of St. Louis Review*, June/ July 1985, pp. 12-20; Stuart E. Weiner, "Payment of Interest on Reserves," *Federal Reserve Bank of Kansas City Economic Review*, January 1985, pp. 16-31; Joanna Hayward Frodin, "The Tax/Subsidy Relation Between Member Banks and the Federal Reserve System," *Journal of Monetary Economics*, January 1980, pp. 105-119.

17 These figures were derived by multiplying the required reserves of commercial banks by the average interest rate in 1990 on three-month Treasury bills. Of course, banks would have had to pay corporate income tax on the extra profits if the Fed had paid them the interest.

18 Canto, *op. cit.*, pp.7, 11.

The federal deposit insurance system, as currently structured, reinforces the perverse incentives and costs associated with reserve requirements. Because deposit insurance premiums are assessed as a flat-rate percentage of a bank's total domestic deposits, the premiums also are in many ways more like an excise tax on bank deposits than true insurance premiums. Just like reserve requirements, deposit insurance premiums add to the cost of taking deposits, reduce the rate of return for stockholders, and encourage banks to make riskier investments to make up for the tax.¹⁹

Doubled Rates. Although the reserve requirement tax was larger than the deposit insurance tax for most of the last two decades, the deposit insurance tax has just overtaken the reserve requirement tax as the largest hidden tax on commercial banks, at least in terms of the total dollar amounts involved. The FDIC has more than doubled the rates it charges for deposit insurance over the last two years, and the Fed recently reduced reserve requirements.²⁰ The recent prediction by FDIC Chairman L. William Seidman that he may have to raise deposit insurance premiums even further, as well as his suggestion that Congress consider assessing all commercial banks a one-time fee equal to one percent of all deposits, in order to recapitalize the FDIC's Bank Insurance Fund, would increase the tax.

The impact of the hidden reserve requirement tax could be avoided either by eliminating reserve requirements or by requiring the Fed to pay interest on all bank reserves kept on deposit with the Fed.²¹ Deposit insurance premiums already are far too high on many well-managed banks because they do not vary with risk. Raising them even further, or imposing a special "one-time" fee, would add to the penalties on safer banks.

19 [Former Treasury General Counsel] Peter J. Wallison, "Destroying the Banks to Save Them," *The Wall Street Journal*, September 28, 1990, p. A14.

20 After remaining at their original level of 8.3 cents per year per \$100 of deposits through 1989, deposit insurance rates jumped to 12 cents at the beginning of last year and 19.5 cents at the beginning of this year. In 1990, commercial banks paid over \$2.8 billion in deposit insurance premiums. However, if the January 1, 1991 increase in deposit insurance rates had been in effect in 1990, the total deposit insurance premiums paid by commercial banks would have been approximately \$4.6 billion. Meanwhile, the Fed eliminated reserve requirements for time deposits and Eurocurrency balances as of last December. One analyst has suggested that the Fed did this specifically to reduce the effect of increased deposit insurance premiums, as well as the effect of higher minimum capital requirements and other regulatory burdens: See Brian S. Wesbury, "The Fed vs. The Regulators," *Chicago Economics*, December 5, 1990.

21 Former Federal Reserve Chairman Paul Volcker has recommended that the interest be returned to the banks. Others have suggested that the money be turned over to the FDIC in order to recapitalize the Bank Insurance Fund.

The Administration Position

The Treasury report does not even address the issue of the financial burden of reserve requirements. It is silent on the case for eliminating reserve requirements or requiring the Fed to pay interest on all bank reserves. Likewise, the report says virtually nothing about the tax-like aspects of deposit insurance premiums. And although the report does warn of the danger of imposing special assessments on the banking industry, in an effort to recapitalize the Bank Insurance Fund, it does not take a position on FDIC Chairman Seidman's proposals.

RESTRICTIONS ON INTERSTATE BANKING

American banks face severe legal restrictions against transacting business across state lines. This makes them especially susceptible to regional economic downturns. The McFadden Act, enacted in 1927 and amended in 1933, prevents federally-chartered banks from having branches in more than one state. Thus a federally-chartered bank in New York may open a branch in Birmingham, England, but not Birmingham, Alabama.²² Moreover, even branching within a single state was until recently sharply restricted.²³ Banks can avoid these state and federal branching restrictions to a limited extent by forming bank holding companies.²⁴ However, rather than functioning as branches of a single bank, banks owned by a holding company must maintain separate corporate identities. This makes branching through a bank holding company substantially more expensive than simply establishing a new branch

22 Under the International Banking Act of 1978, U.S. branches of foreign banks are subject to the same geographic restrictions within the United States as federally-chartered U.S. banks.

23 The extent to which banks are allowed to branch within a given state is governed by state law. The McFadden Act allows national banks to branch within their "home" states to the same extent that state-chartered banks are permitted to do so. Different states had different rules when the McFadden Act was passed. For example, California allowed branching statewide without restriction, New York divided the state into regions and allowed branching within regions but not statewide, and Texas prohibited branching altogether. Today nearly all states, including New York and Texas, allow intrastate branching.

24 Section 3(d) of the Bank Holding Company Act (BHCA) of 1956, better known as the Douglas Amendment, prohibits acquisition of a bank by a bank holding company whose principal operations are conducted in another state, unless the state in which the bank to be acquired is located has passed a statute expressly authorizing acquisitions of in-state banks by out-of-state bank holding companies. Although most states now permit out-of-state bank holding companies to own in-state banks, there are still four that do not: Hawaii, Kansas, Montana, and North Dakota.

of the same bank. Not only are there additional legal fees involved in setting up all the additional corporate entities, but each bank must have its own board of directors and duplicate a variety of administrative functions.²⁵

Sensitive to Local Conditions. Because of restrictions on intrastate and interstate banking, the U.S. has far more banks than most other countries. There are about 12,500 American commercial banks, compared to about 900 in Germany, 550 in Britain, 150 in Japan, and fewer than 70 in Canada.²⁶ Restrictions on branching mean that American banks tend to be much smaller than banks in other countries. They are also much more sensitive than foreign banks to local economic conditions or defaults by a few major customers — a problem that would be substantially reduced if they were allowed to take deposits and do business nationwide.

State restrictions on intrastate branching have helped trigger several bank crises. For example, branching restrictions in Illinois were one major factor in the near collapse of Continental Illinois National Bank and Trust Company in Chicago in 1984. The bank was bailed out by the FDIC before it had actually collapsed, at a cost of some \$4.5 billion. By contrast, the Bank of America in California had loan problems similar to Continental's at about the same time, but it remained solvent in part because California allows branch banking.

Depression Lesson. Federal law compounds the problems caused by state restrictions. If banks in New England and Texas were permitted to operate branches in economically healthier regions of the country, for example, they would not be facing such a difficult time due to the economic weakness of their regions. The greater stability introduced by interstate branching, moreover, is considerable. The comparative international experience of the 1920s and 1930s is particularly striking. Over 9,000 banks failed in the U.S. during the Great Depression. But in Canada, which allows nationwide branch banking, there was not a single bank failure.

Allowing banks to do business nationwide also would make U.S. banking far more competitive than it is today, to the benefit of customers and the national economy. Although the total number of banks would be greatly reduced, mainly through takeovers, the number competing in each local market in most cases would increase. This in turn would lead to better service

²⁵ These and other costs of attempting to pursue interstate banking under current laws, by creating or acquiring bank and nonbank affiliates under a bank holding company instead of establishing actual branches, are discussed in Robert P. O'Quinn, "The Economic Impact of Geographic Restrictions on Commercial Banks" (Washington, D.C.: Federal Trade Commission, forthcoming 1991), p. 9.

²⁶ Nicholas F. Brady, Remarks before the Annual Convention of the Securities Industry Association, Boca Raton, Florida, November 30, 1990.

and lower prices for bank customers. And while many small local banks no doubt would be acquired by larger banks, there would still be significant opportunities for efficient, well-run regional and community banks, which could take advantage of specialized knowledge of the local community.²⁷

The Administration Position

The Administration's report recommends that Congress allow all federally-chartered banks to branch into those states that permit out-of-state banks to own affiliated institutions. This would have the effect of eliminating the McFadden Act's geographical restrictions and the need for cumbersome bank holding companies. The Administration also proposes repeal of the Douglas Amendment three years after repeal of the McFadden restrictions, thereby allowing federally-chartered banks to open branches in all states, including those that currently block out-of-state bank holding companies from acquiring in-state banks. These changes would cover only federally-chartered banks. But as the Treasury report points out, banks with state charters easily could re-charter themselves as national banks if they wished to take advantage of the new federal laws.

RESTRICTIONS ON SERVICES AND INVESTMENTS

Several federal statutes restrict the investments banks can make and the services they can offer. In particular, the Glass-Steagall Act of 1933 created an artificial legal distinction in the banking industry between commercial and investment banks. Investment banks can underwrite corporate equity, acting as the middleman between buyers and sellers of stock offerings. They also can finance corporate debt by handling bonds issued by a business, and offer consulting services to businesses. Commercial banks are prohibited by the Glass-Steagall Act from engaging in most of the activities performed by investment banks. They are restricted primarily to taking deposits and making loans to individuals and businesses.²⁸ The Bank Holding Company Act further restricts bank activities, principally by limiting bank holding companies to those nonbanking activities that the Federal Reserve Board determines "to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." Among other things, this prevents banks from offering mutual fund accounts and from selling insurance or real estate.

27 Michael Becker, *Myths About Financial Deregulation* (Washington, D.C.: Citizens for a Sound Economy, 1988), pp. 9-12.

28 Likewise, the Glass-Steagall Act prohibits investment banks from engaging in commercial lending, although it does allow brokerage firms to offer cash management accounts that allow customers to write checks against their individual stock and bond portfolios.

Defenders of this division in banking argue that allowing commercial banks to go into new types of activities would increase the risk inherent in their business and hence the banks' likelihood of failure. This in turn, it is said, would mean increased losses for the FDIC and the risk to taxpayers of a costly bailout. Just the opposite would be true.

Adding to Instability. The principal effect of these statutes is to prevent banks from diversifying along product and service lines, and thus the laws actually add to risk and instability. The restrictions also reduce healthy competition in both commercial and investment banking, and within the financial services, brokerage, and insurance industries. Another effect of these restrictions is to block large nonbank companies with an interest in financial services, such as Sears, Roebuck and Company, General Motors Acceptance Corporation (GMAC), and General Electric Credit Corporation, from acquiring and recapitalizing troubled banks.

Ending the artificial "wall of separation" between the two halves of the banking industry, and between banks and other financial companies, would provide enormous benefits to consumers. Americans would be able to obtain insurance, buy stocks, and take out a loan for any purpose from the same bank that handles their checking account. Furthermore, those same banks would be less likely to fail in difficult economic times because their business would be more diversified.

Some opponents of removing the restrictions on commercial bank activities argue that deposit insurance would, in effect, unfairly subsidize banks competing with brokerage firms, insurance companies, and other financial service firms. But if anything, the costs associated with mandatory deposit insurance premiums, reserve requirements, minimum capital standards, and other such restrictions that apply only to banks, actually would put most commercial banks at a price disadvantage.²⁹

Congress and the states should abolish all restrictions on bank investments, products, and services. Repeal of the relevant portions of the Bank Holding Company Act and the Glass-Steagall Act, together with the state and federal laws that require savings banks and savings and loan associations to invest mostly in mortgage loans, would accomplish this goal.

The Administration Proposal

To its credit, the Administration proposes substantial reform of the Bank Holding Company Act and the Glass-Steagall Act. Specifically, it would allow

²⁹ Daniel R. Fischel, Andrew M. Rosenfield & Robert S. Stillman, "The Regulation of Banks and Bank Holding Companies," *Virginia Law Review*, Vol. 73, No. 2 (March 1987), p. 328; William S. Haraf, "Financial Structure, the Safety-Net, and the Fallacy of 'Too Big to Fail'" (Washington, D.C.: Citicorp/Citibank, October 5, 1990), p. 4.

some commercial banks to offer securities, mutual funds, and insurance. Unfortunately, the Administration stops short of calling for outright repeal. For example, the Treasury report proposes conditioning entry into new product and service areas on a bank maintaining a specified minimum level of capital. While this would give many banks an incentive to raise their capital levels, possibly increasing their soundness in some cases, it would also have the effect of preventing diversification by the very banks that need it most. In addition, the Administration proposal would force banks to use affiliates if they wished to go into new areas of business, meaning that the new services would have to be provided through separate subsidiaries of a financial services holding company. This cumbersome and unnecessary approach would increase the cost to banks of providing the additional services and reduce the potential gains in efficiency and stability.

Obsession with Capital. This proposal to make bank entry into new services contingent upon higher capital levels, like the proposal to link FDIC insurance premiums to capital levels, reflects a general obsession in the Treasury report with raising the capital levels of banks relative to their total assets. Although the Administration disavows explicitly raising minimum capital requirements, it proposes subjecting banks with relatively low capital to more onerous restrictions and supervision. The obsession with capital is misguided, however. While the Treasury would introduce inducements to encourage banks to raise their capital levels, none of these inducements would do anything to make the banking industry more attractive to investors who provide capital. In fact, they would have the opposite effect.

Government-provided deposit insurance is the principal reason why the capital level of so many banks is so low. Trying to cure the effects of deposit insurance by raising minimum capital standards, or by the capital-focused measures proposed by the Administration, would do nothing to make the banking industry more attractive to investors. The way to change incentives to bolster bank capital is to reform federal insurance, to reduce bank taxes, and to encourage diversification, so that banks become a more attractive, stable investment.

CONCLUSION

The federal regulatory structure poses enormous dangers to America's financial system. If current trends continue unchecked, the American banking industry could encounter the same fate as the savings and loan industry, with an even larger potential bailout cost for taxpayers.

The Administration's proposals, though helpful in many respects, do not go nearly far enough to move the banking industry out of danger. This is especially the case in the area of federal deposit insurance coverage. Indeed, some of the Administration's insurance "reform" proposals actually would be counterproductive, such as its recommendations for tying deposit insurance

rates to bank capital levels and conditioning banks' ability to offer new services on capital levels:

Clearing Perverse Regulations. The Administration and Congress need to recognize that federal regulation of the banking industry is a problem that cannot be corrected by fine-tuning. Instead of trying to refine the regulatory structure and improve the behavior of the regulators, lawmakers should instead clear away perverse regulation and allow market forces to discourage reckless management by banks and to encourage stability through diversification.

William G. Laffer III
McKenna Fellow
in Regulatory and Business Affairs

All Heritage Foundation papers are now available electronically to subscribers of the "NEXIS" on-line data retrieval service. The Heritage Foundation's Reports (HFRPTS) can be found in the OMNI, CURRNT, NWLTRS, and GVT group files of the NEXIS library and in the GOVT and OMNI group files of the GOVNWS library.