The Heritage Foundation Issue Bulletin

No. 167 | The Heritage Foundation · 214 Massachusetts Avenue, N.E. · Washington, D.C. 20002-4999 · (202)546-4400 · Telex:440235

September 30, 1991

A GUIDE TO CURRENT BANKING REFORM LEGISLATION

INTRODUCTION

Committees in both Houses of Congress are finishing work on reforms to the laws governing America's shaky commercial banking sector. Reform is sorely needed. Due to an archaic regulatory structure, America's commercial banks are becoming less competitive in both domestic and international financial markets. Worse still, many banks are vulnerable to downturns in regional economies. This is because restrictions on interstate banking make it nearly impossible for them to reduce the risk posed by economic problems in one part of the country by opening branches in other regions. Limits on the kinds of financial services banks can offer mean they are losing business to other institutions, such as brokerage houses, mutual funds, and finance companies. And taxpayers are in jeopardy because the current federal deposit insurance system charges the same premiums to well-managed and badly-managed banks alike. This offers no incentive for banks to make responsible investments and exposes the American taxpayer to a potential bailout of hundreds of billions of dollars.

The legislation before Congress would remove most restrictions on interstate banking. But while paying lip service to removing limitations on the range of services commercial banks can offer, the bills generally replace one set of destructive restrictions with another. And neither the House nor the Senate legislation seriously addresses the federal banking insurance system's problems. The legislation being prepared for floor debate thus lacks the central features necessary for reform. Without these features, America's banks will be unable to regain their competitive edge, and many may be unable to survive.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

THE URGENT NEED FOR REFORM

Solving the problems of America's banks has taken on a new urgency in recent years. The failure of many savings and loan institutions has meant taxpayers will have to pay out hundreds of billions of dollars to cover losses. The fear now is that, without structural reform, the commercial banking system also may encounter a wave of major failures, leading to an even bigger taxpayer bailout.

Reacting to Scandals. In Congress there has been a tug-of-war between those lawmakers who wish to give banks more flexibility to adapt to a changing financial world and to diversify their portfolio risk, and those who favor only a refinement of today's tight regulation. The recent scandals involving the Bank of Commerce and Credit International and the investment bank Salomon Brothers Inc understandably have made many legislators more reluctant to relax the regulation of banks and to expand their power to engage in new lines of business. This is despite the fact that neither scandal had anything to do with the issues involved in banking reform, or that the conduct involved in each scandal—fraud —would remain illegal even if sweeping banking reform legislation were passed.

The Senate Committee on Banking, Housing, and Urban Affairs has voted on bill language but has not yet completed its report. The Committee's bill, S. 543, probably will go to the Senate floor early next month. In the House, the Committee on Banking, Finance and Urban Affairs completed its work on H.R. 6 in July. The Committee on Energy and Commerce completed its mark-up of the bill just last week.

The current Senate and House versions differ on a number of issues. Among the most important:

♦♦ Geographic Restrictions

Many banks could diversify their loan portfolios and base of depositors, and thus partly insulate themselves against economic downturns in any one state, if they were allowed to open branches anywhere in the country. But the McFadden Act of 1927 and the Bank Holding Company Act of 1956 prohibit most interstate banking and branching. Allowing banks to merge with or acquire banks in other states would make banks less susceptible to regional variations and thereby increase their safety and soundness.

The Committee versions of both H.R. 6 and S. 543 would make it easier for banks to undertake interstate branching. However, the Senate bill would place numerous restrictions on the freedom of banks to engage in business interstate. In particular, it would limit interstate branching to well-capitalized banks, that is banks that have relatively high capital-to-asset ratios. But this would deny the benefits of diversification and risk reduction to the very banks that need it the most—those which have already overextended themselves, or had their capital base eroded by losses on bad loans, and which would be most vulnerable to a regional downturn.

Further, the Senate bill would make all banks, and thus their depositors, pay a price for interstate branching in the form of expanded community reinvestment

requirements. These are legal requirements forcing banks to make a certain percentage of their total loans to borrowers within the local community, although doing so usually requires them to make loans that are much less profitable, and even to borrowers who are not credit-worthy. The House version of the bill expands community reinvestment requirements as well, but does not make them an explicit condition for interstate branching. Thus, the House bill allows banks more flexibility for branching, and in this respect would do more to put the banking industry on a sounder footing.

♦♦ Products, Services, and Investments

To reduce risk even further, banks should be allowed to offer a wider variety of financial services. Currently, commercial banks are limited mainly to providing checking and savings accounts and making loans. But commercial banks should be allowed to engage in other lines of business, such as underwriting the sale of securities, providing brokerage services and mutual funds, and selling insurance to their depositors. This would enable them to be more competitive with other financial institutions by giving their customers the convenience of "one-stop shopping" for financial services. The additional diversification also would enable banks to achieve significant further reductions in their overall portfolio risk.

The Committee versions of both H.R. 6 and S. 543 would repeal the Glass-Steagall Act of 1933, which limits the services that commercial banks can offer. Repeal of this law would give commercial banks the power to sell securities through separately incorporated and capitalized affiliates. The House version, unlike the Senate's, also would allow banks to underwrite insurance, again through separately incorporated and capitalized affiliates. These banking, securities, and insurance operations would have to be subsidiaries of a single parent company, which would be called a Financial Services Holding Company.

Both the House and Senate versions, however, would require substantial "fire walls," or restrictions on dealing between the banking, securities, and insurance operations of a Financial Services Holding Company. These restrictions are intended to protect the taxpayers from having to bail out a bank's non-banking activities, and to prevent government-provided deposit insurance from subsidizing the operations of a bank's non-banking affiliates.

Steps Backward. Such "fire wall" restrictions unfortunately would have the side effect of diminishing the efficiency improvements and other benefits that otherwise would be achieved by combining banking with securities and insurance. Indeed, in the version of H.R. 6 prepared by the Energy and Commerce Committee the restrictions on dealings between commercial banks and affiliated securities firms are so severe that it is doubtful whether banks would find it profitable to affiliate with securities firms, or vice versa. The Committee's bill, moreover, actually would reduce the existing, very limited powers of banks to underwrite or sell insurance. Hence the Committee's bill actually would represent several steps backward, making it even more difficult for banks to achieve stability through diversification. The Bush Administration has indicated that it would rather have no banking reform bill than one containing the restrictions being pushed by the Energy and Commerce Committee.

The versions of the bill in each House also would limit the freedom of banks to pursue product and service diversification. Diversification would be permitted only for banks that have relatively strong financial positions. But the banks most at risk today generally are those with weakened financial positions. So the restriction would have the effect of denying the benefits of diversification and risk reduction to those banks that need it most.

♦♦ Mixing Banking and Commerce

The Bush Administration wants to change existing banking laws to allow commercial firms such as General Electric, General Motors Corporation, and Sears Roebuck and Company to own commercial banks. These and similar firms already offer, either directly or through subsidiaries, consumer loans, brokerage services, insurance, and even real estate, but they cannot own a bank.

There are three potential advantages from such a change in the law. First, commercial firms represent an enormous source of capital to shore up troubled banks. If commercial firms are allowed to own banks, then many bank failures would be avoided. But if commercial firms are not allowed to bail out segments of the banking system, the taxpayers may have to.

Second, if commercial firms are allowed to purchase banks, the commercial firms could integrate banking operations with their other businesses. For example, Sears could offer banking services in its retail stores, along with the insurance, securities, and real estate services it already offers through its Allstate, Dean Witter, and Coldwell Banker subsidiaries. Consumers then would have the opportunity of "one-stop shopping" for all their major financial services.

Third, ending the artificial separation of banking and commerce is essential if the financial sector of the economy is to become more efficient and competitive. Many securities firms and insurance companies already are subsidiaries of commercial firms. If banking is to be combined efficiently with securities and insurance, commercial firms must also be allowed to own banks.

Although the version of H.R. 6 passed by the House Banking Committee would allow commercial firms to own banks, as the Administration has recommended, the version prepared by the House Energy and Commerce Committee would not. The Senate bill currently does not include a provision to eliminate the restrictions on bank ownership by commercial firms.

♦♦ Deposit Insurance

A major cause of the problems of U.S. commercial banks stems from the manner in which the Federal Deposit Insurance Corporation (FDIC) insures banks. The FDIC, a federal agency which itself is underwritten by the taxpayer, insures the vast majority of the nation's banks. But its insurance rates are the same for all banks, no matter whether they follow sound banking practices or not. Further, while only $100,000 of each account is insured, there are no limits on the number of accounts a customer can have. Hence, there is little reason for almost any customer to be concerned about banking practices of his or her bank. This encourages banks to offer higher rates of return—often financed by riskier loans —rather than soundness as a means of attracting depositors. The Federal Savings

and Loan Insurance Corporation used the same policy of flat-rate premiums to insure the nation's thrifts. This encouraged the high-risk lending of many savings and loans, adding billions to the cost of bailing out the industry.

Reflecting Risk. The FDIC should at the very least charge variable rates of insurance reflecting the soundness of a bank's loan portfolio, just as automobile insurance companies charge lower rates for good drivers and higher rates for accident-prone drivers. Insurance should be limited to one account per person. And ideally, insurance should be transferred to the private sector, so that investors in insurance companies, not taxpayers, would face the risk and so would demand more sensible premium policies. Although the Committee bills in both Houses would make some changes in the deposit insurance system, neither bill goes far enough.

Each bill would require the FDIC to develop and introduce some form of risk-based premium pricing. But neither bill would reduce the current coverage limit of $100,000 per account or the total number of insured accounts one individual may have. The House bill, however, would limit the number of insured accounts an individual may have with a single institution.

In addition, both bills would set up pilot or demonstration projects to study the feasibility of relying on private insurance to protect depositors, either instead of or in addition to the current government-provided insurance. However, a provision in the House bill inserted in the Banking Committee by Representative Jim Leach, the Iowa Republican, actually would prohibit the existing private deposit insurance used by some credit unions by requiring all credit unions and all other state-chartered depository institutions to be insured by the federal government. This provision, for instance, would block the recent decision by a private credit union insurance company in Ohio, owned and controlled by the credit unions it insures, to restructure its operations and introduce risk-based pricing. Currently this company operates just like the FDIC: all insured member credit unions pay the same premium rate. Under the revised plan, however, the member institutions will monitor each other's performance, and each institution will pay a premium based on the risk it poses to the other institutions insuring it. If allowed to go ahead, this plan could make private risk-based insurance a reality.

♦ ♦ Tax Burden on Banks

Another problem that neither bill addresses is the heavier taxes paid by banks, compared with their competitors. Banks pay a hidden tax that other financial institutions do not have to pay. This tax arises because of the manner in which banks are subject to reserve requirements. Banks must keep a certain percentage of their funds on deposit with the Federal Reserve System. These reserve requirements are intended to limit credit creation and control the supply of money. The practical effect of reserve requirements, however, is to compel banks to lend $12 to the federal government, interest-free, for every $88 they lend to the private sector. Hence banks are, in effect, subject to a tax equal to the interest they could earn on these deposits if lent to private borrowers. One way to eliminate this tax, and put banks on an equal footing with other institutions, would be to require the Fed to pay interest on banks' reserve balances.

♦♦ Rising FDIC Premiums

The premium banks must pay for deposit insurance has risen in the last two years from just eight and one-third cents per year per hundred dollars of deposits to 23 cents per year. While some banks should be charged more for deposit insurance, based on their financial condition and the quality of their loan portfolios, the current 23-cent rate already is too high for the vast majority of banks. Further raising the premiums charged to all banks to cover the losses caused by the risky few could trigger the eventual demise of America's banking system. Quite separate from the need to vary the premiums according to risk, the average deposit insurance premium rate charged by the FDIC should be lowered from its present level.

Congress appears likely, however, to put pressure on the FDIC to raise premium rates even higher in an effort to cover predicted losses. Although neither bill mandates an increase in rates, both bills authorize the FDIC to borrow up to $70 billion from the Treasury, with the loan to be repaid out of future deposit insurance premiums. But even if this stop-gap measure passes, the FDIC should not have to raise its premium rate to repay the loan. A recent analysis by Alexandria, Virginia-based banking economist Bert Ely indicates that the FDIC can cover all foreseeable failure-related expenses, including interest on its loan from the Treasury, with the existing rate of 23 cents. Although the bank insurance fund is likely to endure a deficit for approximately three or four years, the number of bank failures eventually can be expected to decline sharply, and the fund will return to a large positive balance after 1996.[1] Raising the premium rate above 23 cents, however, will cause more banks to fail. Worse still, further increases in premium rates could threaten the very survival of the banking industry.

CONCLUSION

It now appears increasingly unlikely that Congress will be able to complete work on a banking reform bill this year, let alone produce a bill that will represent a genuine step forward. The most likely outcome this year is a bill that simply authorizes the recapitalization of the bank insurance fund, so that the FDIC will have enough funds to stay in business. While there is still a chance that legislation will pass authorizing interstate branching, it appears unlikely that the powers of banks will be broadened in other beneficial ways. It also appears unlikely that there will be sufficient reform of the deposit insurance system to remove today's perverse incentives.

Structural Reforms. Congress should not fall into the trap of focusing more on the bank insurance fund than on the health of the banking system itself. Any effort to bolster the bank insurance fund at the expense of the banking system likely will weaken both. Needed instead is legislation that makes banks more

1 Bert Ely, "Deposit Insurance Myths Threaten Banking Industry," *American Banker*, August 19, 1991, p. 5.

stable and competitive. Such legislation must allow interstate branching without restriction, so that all banks can diversify their loan portfolios and their depositor bases. This would protect banks from regional downturns. The legislation also should permit banks to diversify their products, services, and investments, thereby reducing their portfolio risk while giving their customers the convenience of "one-stop shopping" for financial services. It should also allow commercial firms to buy troubled banks and integrate their operations. And most important to the long-run health of the banking industry, reform legislation must introduce true risk-priced deposit insurance premiums, preferably through the private sector. This would substantially reduce premiums for most banks but raise them for the riskiest banks.

Ignoring the need for structural reform will only prolong and exacerbate the problems faced by America's banks and increase the ultimate cost borne by the taxpayers.

William G. Laffer III
McKenna Senior Policy Analyst 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.