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Regulation and the Future of Banking

by Jerry L. Jordan

The future of banking cannot be discussed without talking about regulation. Simply put, regulation is what has defined banking as we know it. For more than 60 years, the Glass–Steagall Act has defined what a banking organization has been allowed to do; the Douglas and other bank holding company acts have defined the corporate form required to do it; the national or state banking authorities, deposit insurance agencies, and Federal Reserve have defined how to do it; and their supervisors and examiners have tried to ensure that it was done that way.

The reason we can discuss the future of banking without focusing *entirely* on regulation is that the current highly fragmented regulatory structure simply will not serve the needs of the twenty-first century. The power of private property rights operating through a market economy is that, if consumers want something and are willing to pay the price, producers will find a way to supply it. Regulatory restraints impede market adjustments to shifting demands. Emerging technologies and individuals' ingenuity will ultimately get over or around those regulatory barriers, but it will take time and absorb resources.

In short, regulation "gums up the works." In the end, it will not prevent producers from satisfying consumers' desires except at the margin, where higher costs and prices convey the burden of regulation to the consumers who must bear it.

I am optimistic enough about our political system to believe that if a regulation is not producing some benefit commensurate with the burden it imposes on consumers, such regulation eventually will be removed — if not erased, then at least not enforced. To start envisioning the future regulatory environment of banking, we can pose two questions. What kinds of regulation will be necessary in the future, and how fast might we expect to move from today's outmoded system to an era in which different regulations make more sense?

Regulation Today

Our current regulatory framework is a product of the 1930s, designed under emergency conditions of economic depression that we all hope henceforth will be irrelevant. More important, the regulatory framework was created on the crest of the intellectual wave of belief that government intervention could make the world better by planning and controlling economic activity.

Now, despite stunning advances in computer and communications technology that might facilitate centralized control, the wave of belief in the efficacy of government intervention has crashed. As a result, hundreds of millions of people around the world have been freed to rely on their own initiative and on private markets, without conforming to a government plan — *except* in our financial sector. Here, statutory distinctions remain in place, guiding financial activities.

How must the regulatory structure of the financial industry change to meet the needs of the next century? The answer involves dismantling traditional partitions that have separated firms, rethinking functional regulation policies, and squarely facing the problem of moral hazard created by the federal safety net.

The landmark financial legislation of the 1930s created distinctions among three financial market boxes — labeled "depository institutions," "securities underwriting and sales," and "insurance underwriting and sales." In principle, each of these gigantic boxes could be subdivided into constituent compartments: Depositories included separate compartments for commercial banks, savings and loans, mutual savings banks, credit unions, and industrial banks; the securities industry was subdivided into brokerage firms, securities dealers, mortgage companies, and finance companies; insurance included brokers, dealers, underwriters, and rating agencies.

As long as all these compartments contained separate, noncompeting markets, then regulators could try to enforce different rules within each box. With little danger of substitution, the costs of regulation could be added to price in one compartment without many customers fleeing to other compartments. Regulators' rules could be defined to secure a public purpose thought to be superior to the results of unregulated competition within each compartment.

Today, these Glass–Steagall regulations still force depository institutions to fit themselves into one box only. Regulations are still designed as though banks do not compete with firms in the other boxes. Nevertheless, depository institutions, securities firms, and insurance companies all cater to the needs of common customers.

Regulation in the Future

Sometime in the future, these arbitrary regulatory boxes will be thrown away. Over the years, in fact, any natural walls separating financial compartments have largely fallen away, leaving increasingly flimsy partitions made up of regulatory restrictions whose major purpose was to preserve tidy compartments.

Three kinds of restrictions have been used to maintain these partitions: restrictions on price, restrictions on location, and restrictions on product. In general, price restrictions are no longer important in banking. For example, Federal Reserve Regulation Q, which set differential maximum interest rates on time and savings deposits at banks and thrifts, was dismantled between 1980 and 1986 in compliance with the Monetary Control Act.

Statutory prohibition of interest payments on demand deposits, enacted to prevent bank failures due to destructive competition, is largely irrelevant today. Increasingly, with everyone wired together by telecommunication networks, the ability to access interest-bearing credit balances on the books of every reputable firm will make useless any arbitrary definition of a "deposit."

Regulatory restrictions on location also are a dead issue for the future of financial services. Under the provisions of last year's Riegle bill, almost-universal interstate branch banking will be possible and seems likely after 1997, unless an unexpectedly large number of state legislatures vote to opt out.

In addition, the end of product restrictions is near. For example, a principal argument for the separation of commercial from investment banking under the Glass–Steagall Act was that, if the two were combined, banks would use their underwriting business to repackage their bad loans as bonds, which they then would foist off on a gullible public. Neither logic nor historical evidence supports this argument. Customers are not dupes, and a bank's long-run investment in reputation is not worth throwing away for any short-term profit gained from selling bad bonds.

If there is to be any product regulation in the future, it should not follow today's approach, under which bank regulators require companies to ask permission to change what they are doing. Banks have needed permission to branch, to merge, to form a holding company, and to acquire a subsidiary or affiliate. The underlying philosophy has been, and remains, "Prove to the authorities that you should be allowed to do this."

I have a fundamental philosophical objection to this approach. Constitutionally, government is supposed to bear the burden of proof if private citizens are to be constrained from following the dictates of self-interest. Instead, banking regulation forces private citizens to bear the burden of proof that they be permitted to act in their own self-interest.

We should put the shoe on the other foot. Adopt an information approach, closer to that of the Securities and Exchange Commission (SEC). Let firms notify regulators of an innovation, then let the regulator take the initiative to intervene within a reasonable time with a demonstration that costs exceed benefits. Let the public record and accounting statements reveal what firms are doing and how well they're performing in the market. This is not heresy. Other nations do it in banking, and in this country, regulators outside of banking do it. We're not in the 1930s—let producers take responsibility for what they do.

Functional Regulation

Doing away with Glass–Steagall boxes will not clean the future regulatory slate entirely. The legal framework of finance and commerce will remain, including laws that discourage fraud and misrepresentation, guard against anticompetitive practices, and require timely release of accurate information.

It is less obvious what to expect about so-called "functional regulation" in the future. Functional regulations are those rules unique to each of the Glass–Steagall boxes and compartments. Examples are SEC shelf registration in the securities box, reserve requirements in the banking box, and policy reserves in the insurance box.

Reserve requirements provide a good example of a functional regulation moving toward extinction because its costs exceed its benefits. Reserve requirement levels have been reduced repeatedly over the past 60 years, just as developments in computer technology have made them cheaper to avoid.

The potency of a functional regulation should be expected to decline when costs rise relative to benefits. This may seem to be an encouraging lesson about the rationality of our regulatory world. Note, however, that rationality prevails only in the present. No matter how convincing the initial case for adopting a regulation may be, it must be reassessed continuously. Sunset provisions are the effective way to ensure reassessment: Let regulations lapse on a known date unless proponents can muster new evidence of a net benefit.

Regulation and Moral Hazard

It might be nice to stop here, saying that we should look forward to an unregulated financial services industry in the next century. The reason I cannot stop with that is the same reason that Congress has had such difficulty in adopting financial reform legislation.

Moral hazard is the problem. It is created by the federal safety net, including Fedwire finality, the discount window, and deposit insurance. The financial structure of the future will depend largely on what is done about moral hazard.

Transactions deposit liabilities of depository institutions are a primary medium of exchange in our economy and a primary store of value in our financial system. Businesses that have access to the safety net thereby are better credit risks in some ways than those without access. Lenders who give credit to those with access need not be as painstaking in their credit evaluations or can lower the risk premium they demand when lending, because they are aware that the safety net is available. In these ways, the safety net subsidizes borrowing and risk-taking by those with access.

The tough problem is how to remove restrictions between the payments business of banking and all the other businesses in which an unfettered conglomerate firm might want to engage. How can banking become part of everything else without, at one extreme, removing the safety net subsidy or, at the other extreme, extending both the safety net subsidy and prudential supervision to everything else? Between these two extreme solutions are a few more familiar suggestions:

- Proponents of "narrow banking" would charter specialized, safe banks, allowed to invest only in cash and other ultrasafe assets and to issue monetary liabilities. All other financial and nonfinancial business would be conducted from firms with no safety net available to them.

- Advocates of "firewalls" aim at a similar result. Some proposals, such as that of Jim Leach, chairman of the House Banking Committee, would allow both bank and nonbank subsidiaries within a financial services holding company. Only the bank subsidiary would have access to the safety net, with limitations on overlapping personnel and intersubsidiary transactions to limit spillovers of the safety net subsidy to other lines of business.

- Other proposals, associated with the current administration and the Office of the Comptroller of the Currency, would rely on the formation of bank subsidiaries, rather than on holding company affiliates, to carry on the nonbanking activities of a conglomerate firm. How this proposal would deal with moral hazard is unclear.

- Coinsurance is a feature that could be combined with others, as long as no bank were considered "too big to fail." Coinsurance would pull back from 100 percent insurance of deposits within the current $100,000 per account limit. Instead, starting at zero or more, depositors would absorb a portion of any loss. This would reintroduce into deposit markets some of the discipline that safety net guarantees have removed.

How Soon Is the Future?

Some contend that this is the year for financial reform legislation. Of course, such things have been said before, but all we saw were piecemeal revisions. Last year's interstate branching legislation was perhaps the most substantial change since Glass–Steagall.

I do see reasons, however, for thinking that the current Congress will enact more complete reform legislation. A number of powerful forces are at work that, in combination, suggest that something *must* happen, and soon.

First, banks, their competitors, and their customers are in the process of planning for the new interstate banking environment of 1997. But planning what? To plan effectively, they need either affirmation that existing regulatory ground rules will not be removed, or, alternatively, a sense of the extent to which financial reform will proceed. Congress can expect a lot of pressure from major players who are tired of procrastination and who need a more definitive basis on which to plan for the next five to ten years.

The second reason for expecting genuine reform is the visible disequilibrium in the regulatory framework itself. The structure dictated by the Glass–Steagall Act, which successfully prevented banks from doing new things for several decades, now seems to be disintegrating before our very eyes. The Office of the Comptroller of the Currency has made a preemptive strike at reform, suggesting that it may offer national banks substantially greater freedom to enter nonbanking lines of business through bank subsidiaries. If this effort prevails, the always-delicate balance between the attractions of national and state charters will be tipped decisively. For state charters to regain franchise value, substantial further steps will need to be taken to loosen regulatory constraints on state-chartered banks, their branches, and their holding companies.

A third reason to expect congressional reform is the deposit insurance premium issue, which in the short run is building even more insistent pressure for change than the Comptroller's initiatives. The Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) both charge close to the same premium. BIF premiums are slated to drop soon, because the insurance fund has been replenished after a severe drain a few years ago. SAIF premiums for thrift deposits, however, cannot be reduced in the foreseeable future because the SAIF insurance fund has not been replenished, and because SAIF premium income also services the bonded indebtedness of the Financing Corporation (FICO). The result is an impending 19-basis-point cost and price disadvantage for thrift deposits.

Already, the BIF/SAIF issue is having predictable results. SAIF members that are in sound condition are applying for BIF-insured bank charters in order to channel deposits to the banks. As a result, SAIF will be subjected to a fundamental shock that, if left to play itself out, would leave the fund insuring the residual deposits of institutions unable to escape. SAIF premium income would decline, and FICO bond service would be in jeopardy.

This unresolved issue illustrates a powerful disequilibrium in the financial markets today that will not be ignored. Instead, it promises to become part of the political horse-trading and congressional logrolling that will produce fundamental reform of the regulatory structure of U.S. financial markets.

Underlying all of these pressures for change is a fourth, more fundamental force. The 1930s' intellectual conceit that subdivided businesses and products into neat regulatory boxes and compartments was nothing more than that — a conceit. Changing technology alone doomed this effort. Especially as the computer and telecommunications revolution created boundless opportunities for innovation, including money market mutual funds and sweep accounts, the compartments became purely imaginary regulatory constructs.

The end is not in sight. ATM network sharing and credit card companies have produced nationwide — approaching worldwide — networks that only visionaries imagined possible 20 years ago. Close to 30 percent of U.S. households have home computers of some description. It's not outlandish to expect that telecommunications networks like Internet will link a critical mass of households and almost all businesses within a few years. The opportunities this creates for innovations in commercial and financial markets cannot be predicted, but surely are enormous. Just as great, I believe, are the opportunities for crossing Glass–Steagall boundaries among regulatory compartments.

Conclusion

The regulatory structure of the 1930s is disintegrating, but financial reform involves both a rock and a hard place. The hard place is the inevitable jockeying of various interest groups to advance their respective competitive advantage. Each group claims to want its own version of reform, and contends that no reform would be preferable to the proposals favored by other groups. However, the rock that prevents movement past this hard place is how to limit access to the federal safety net.

How can legislation remove the regulatory partitions without thereby removing the full measure of market discipline from activities newly associated with payment services? Can the federal agencies provide credible assurance that they will not come to the rescue of firms that get into trouble in activities other than payments? Will reform be possible without taking the path of least resistance, the path of broadening access to the safety net? All I can say is, "Stay tuned."

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