CHAPTER 5

Financial Market Deregulation

OVER THE PAST FEW YEARS, financial markets have undergone sweeping changes of a magnitude not seen since the 1930s. Despite these changes, the process of market restructuring and regulatory reform remains incomplete. Additional regulatory changes of historic dimensions are being debated. The shape and scope of these reforms will be important to the American economy for decades to come.

The issues in financial regulation are many and complex. They include the safety and soundness of financial institutions, the problems of dealing constructively with changing technology, and the reduction of regulatory burdens to the maximum extent possible. Similar concerns are important in other industries where regulatory reform is being debated. But the financial regulatory reform issues are in many respects far larger.

Financial regulation is not simply a matter of protecting poorly informed investors—the usual focus of consumer protection regulation—but of protecting everyone. In the financial crises experienced in 1933 and earlier in U.S. history, well-informed, prudent investors and depositors found themselves ruined financially. From painful experience, we know that a failure of public policy with respect to financial markets can create damage that extends far beyond the financial services industry. Financial market failure can mean economy-wide failure—recession, widespread unemployment, and bankruptcies.

The essential functions of financial regulation are to ensure the safety and soundness of the financial system, and to foster efficient allocation of capital by promoting competition and limiting opportunities for fraud and self-dealing. The competitive capital markets in the United States, long encouraged by public policy, have provided highly efficient links between the providers of funds and the users of funds, directing resources into the most productive investments in the economy. But instability in financial markets has been a continual concern, and at times a highly disruptive fact, throughout U.S. history. The challenge for regulatory policy is to maintain stability while realizing the benefits of competition.

MAJOR HISTORICAL FORCES SHAPING FINANCIAL REGULATION

It is best to begin the analysis of the key financial regulatory issues by considering the major forces that have shaped the industry and led to the present regulatory environment. These forces have included public reaction to periods of financial instability that occurred in the 1930s and earlier, public concerns over the credit powers of financial institutions and their ties with other institutions, and strong competitive pressures coming from both within and among the various segments of the industry.

FINANCIAL INSTABILITY

Much of our inherited regulatory structure involves extensive and far-ranging legislation enacted in response to crisis. Periods of acute financial instability have resulted in the disappearance of major institutions and the introduction of new governmental regulations. For example, in the 1860s, problems of Civil War finance and increasing currency disorders led the Congress to establish the national banking system and the Office of the Comptroller of the Currency. The Congress also defined the arrangements under which national banks would issue a national currency. Later, a series of banking panics—periods of numerous bank failures and bank suspensions of payments—culminating with the panic of 1907, created demands for a stronger Federal mechanism to prevent instability. This led to the establishment of the Federal Reserve System in 1913.

In the 1930s, the collapse of the banking system and the Great Depression led to major banking and securities acts that set the basic structure of our banking and financial regulation. The legislation, among other things, established the Federal Deposit Insurance Corporation, the Federal Home Loan Bank System, and the Securities and Exchange Commission.

The basic problem of financial instability that existed before extensive Federal involvement to stabilize the system arose because banking is based on a fractional reserve system. Banks accept deposits payable on demand. To meet depositors' demands, banks maintain reserves of cash and liquid assets that are a fraction of total deposits. In normal circumstances, the net drain on a bank's cash and liquid assets is small, because some depositors are putting funds into the bank while others are taking funds out. Moreover, if one bank is running short, another bank ordinarily has surplus funds. Bank funds can be borrowed and lent in the interbank market, known as the Federal funds market. This market is extremely large and well developed.

In the financial panics that occurred in the 1930s and earlier, however, depositors came to distrust banks; they withdrew funds and held them in the form of currency. One bank's deposit drain was not offset by another bank's deposit inflow. Because bank assets consist partly of cash reserves but mostly of loans to households and businesses, banks experiencing cash drains were forced to curtail lending, and perhaps to liquidate outstanding loans. As a result, borrowers were forced to scramble for funds. Business activity and employment fell, and interest rates on business and consumer borrowing often rose.

As the business contractions continued, previously sound firms found that they could not service their debt, nor could unemployed workers pay theirs. Banks that had been unaffected by the developing crises found that their once sound loan portfolios had become shaky. Fearing more bank failures, depositors rushed to withdraw funds from those sound banks. As the downward pressures accumulated, the financial crises deepened.

This brief description of the development of financial crises shows that a financial system based on fractional reserve banking is potentially unstable: given a big enough shock or disturbance, rational and predictable responses by banks, businesses, and households will tend to make the problem worse. There need be no villains for a financial crisis to occur. A crisis could develop even though every participant acted responsibly.

Two types of governmental institutions now serve to prevent a financial panic from cascading into a collapse of the banking system. First, the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, and the National Credit Union Administration provide deposit insurance so that the failure of one unhealthy institution will not produce panic runs on healthy institutions. Second, the Federal Reserve System, as the Nation's central bank, stands ready to provide extra liquidity to the banking system. When a scramble for a relatively fixed amount of currency threatens to produce a crisis, the Federal Reserve can increase the total amount available, thus meeting extraordinary demands. A scramble for currency forces cumulative reductions in the total money stock, but the Federal Reserve can prevent the process from starting in the first place by using its policy instruments to keep the money stock growing reasonably smoothly.

CREDIT POWERS OF FINANCIAL INSTITUTIONS

A major theme running through U.S. financial history is that of concern over the power of financial institutions, primarily banks, as lenders, and not just as depositories. This concern is responsible for many banking and financial market regulations. Issues of competition and concentration, of fair and reasonable interest rates, and of equitable access to credit, have long been controversial topics in the regulatory debates.

It is essential that monetary and credit issues be kept analytically separate. We have tended to extend regulation over the credit activities of financial firms because of incomplete understanding of the monetary functions of banks. For example, although there is no evidence to support this proposition, bank failures in the early 1930s were attributed in part to the role of banks in the securities business. This belief led to provisions in the Banking Act of 1933 (Glass-Steagall Act) requiring the separation of banking and securities activities. Similarly, regulations setting minimum margin requirements for securities purchases, prohibiting the payment of interest on demand deposits, and limiting the interest paid on time and savings deposits, were based on the view that regulation of the credit markets was necessary to ensure financial stability.

The evidence, however, indicates that banking abuses are not themselves the basic cause of financial instability. A steady stream of bank failures occurred in the 1920s without causing generalized financial stress. On the other hand, in the absence of a proper governmental monetary framework, there is a danger of banking system collapse even if all banks individually pursue sound and conservative banking policies.

THE FORCES OF COMPETITION

Competitive pressures have been an important force in shaping the financial industry. Yet much of the legislation of the 1930s, and in other periods as well, has been designed to restrict competition, particularly in banking, so as to maintain financial stability. Much of this legislation rested on faulty analysis. Indeed, restrictions on competition have not only led to costly inefficiencies in the provision of financial services and reduced consumer choice, but also may have contributed to instability.

The forces of competition in financial markets are powerful. The organized exchanges and over-the-counter markets in standardized financial instruments are obviously highly competitive. What is less obvious is the competitive nature of transactions involving nonmarketable financial instruments. For example, a bank's loan to a small business or a household, which is ordinarily not a marketable financial instrument, is often negotiated in a competitive setting. In many areas of the country borrowers can choose among numerous possible lenders. By shopping around, they can select the most favorable combination of interest rate, terms, and service. In doing so, they constrain lenders to provide competitive loan rates and terms.

Although most financial markets are highly competitive for most participants, there are exceptions. In some cases geographical restrictions reduce the competition in local markets because financial firms from other areas are denied entry. The loss of competition primarily affects smaller local businesses and households; larger businesses can place deposits with, and obtain credit from, the larger financial firms competing in regional or national markets.

One measure of the depth of competition among financial firms in the United States is that there are more than 35,000 independent banks, mutual savings banks, savings and loan associations, and credit unions with approximately 100,000 offices nationwide. To be sure, some part of this large number may reflect unit banking and other restrictions, but it is likely that even without such restrictions the number of depository institutions would be large. In addition, insurance companies, securities firms, money market mutual funds, finance companies, and other types of financial institutions compete with the depository institutions in providing many services. Table 5-1 provides data on the numbers and assets of these institutions. Finally, many large borrowers can bypass financial intermediaries altogether by selling stocks, bonds, and commercial paper directly to the market.

TABLE 5-1.—*Number and assets of selected financial institutions as of December 31, 1982*

Type of institution	Number	Assets (millions)
Commercial banks	14,543	1,862,724
Branches	40,349	
Savings and loan associations[1]	3,833	706,045
Branches	18,712	
Mutual savings banks	424	174,197
Branches	2,777	
Credit unions[2]	16,589	76,120
Money market mutual funds[3]	255	221,558
Life insurance companies	2,060	588,163
SEC-registered broker-dealers	8,299	

[1] Data are preliminary.
[2] Excludes approximately 3,400 nonfederally insured State credit unions.
[3] Data as of December 29, 1982 for funds reporting to Donoghue's Money Fund Report.

Source: Compiled by Council of Economic Advisers.

There is an important consequence of this competitive environment. Many of the regulations put in place in the 1930s that were designed to prevent "excessive competition" have been eroded by pressure for efficiency and innovation. In many instances profitability can be improved by avoiding costly regulation. When firms find ways to avoid regulation, other firms are attracted to similar strategies, both to maintain their profitability and to protect their competitive positions.

Although the forces of competition usually prevail in the long run, the costs of unnecessary regulation should not be ignored. The amount of unproductive labor devoted to regulatory compliance and avoidance is far from trivial. Moreover, established firms can find their market positions, expertise, and capital eroded as they attempt to cope with outmoded regulatory constraints while competing against less constrained firms. Regulation, more than restraining competition, forces it into new channels. As a result, resource allocation is distorted and unnecessary costs are imposed on consumers, shareholders, and taxpayers.

The importance of the competitive constraint on financial regulation can hardly be overemphasized. But neglect of it in the past has led to many of the regulatory problems the Nation has faced. Important recent examples include the market distortions engendered by ceilings on the interest rates financial institutions were permitted to pay to their depositors, and the growing banking competition from nonbanking firms such as securities firms that are not subject to traditional banking regulations.

Many observers decry the effects of competition in breaking down regulation, but it is not possible to obtain the benefits of competition—the market constraint on interest rates, the incentives for efficiency and innovation, and the dispersion of economic power—without having these same forces work toward the avoidance of regulation. Indeed, competition may break down unwise regulation that never should have existed.

It is often the case that legislation designed to solve one problem creates others. Most observers agree that the danger of a financial crisis has been reduced to an extremely low level. However, deposit insurance, interest rate controls, and other restrictions on bank activities introduced in the 1930s—initiatives viewed at the time as contributing to financial stability—have had unexpected side effects.

Recent legislation, the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982, have begun to deal with these new issues. Fortunately, the new legislation has been enacted in a setting very different from the crisis atmosphere existing in the 1930s. To be sure, recent years have seen major stresses on the financial system; the failure rate of financial institutions has risen. But the driving force behind recent and newly proposed legislation has been an attempt to modernize the regulation of financial markets and institutions—to retain what is essential in earlier legislation and sweep away what has proved unnecessary or counterproductive.

The market's response to interest rate ceilings on time and savings deposit accounts provides an example of regulatory avoidance in a highly competitive market and the unnecessary costs incurred in the process. Interest rate ceilings evolved from the legislation of the 1930s. The intent was to restrain "excessive price competition," then thought to have contributed to the banking collapse in 1933. It was also felt that the introduction of Federal insurance of bank deposits gave the government a special responsibility to protect the commercial banking industry from competitive pressures that might strain the resources of the insurance funds.

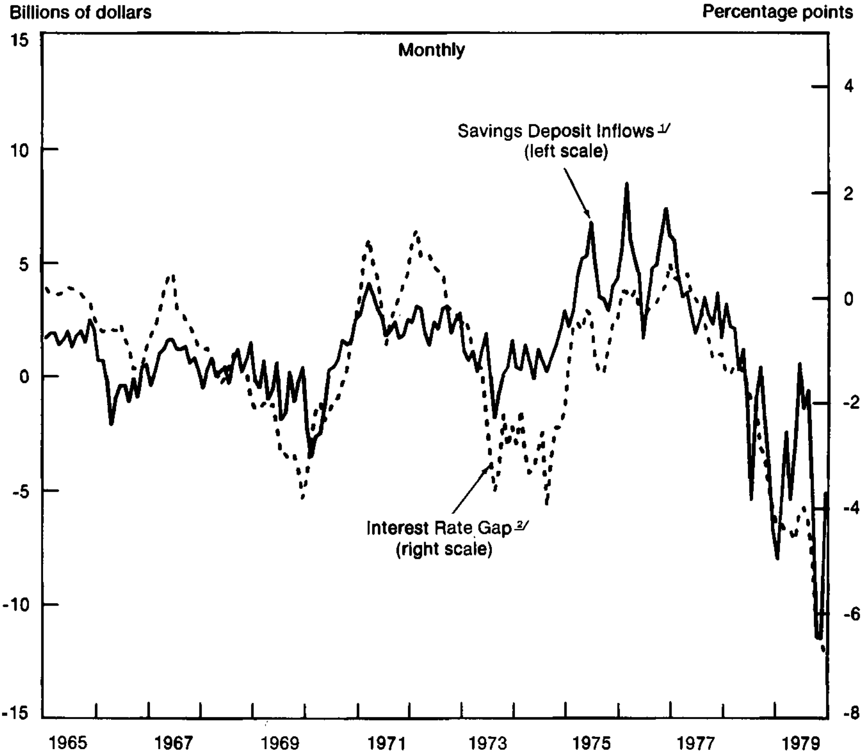
Until 1966 interest rate ceilings on commercial bank deposits were intermittently changed to remain above market interest rates. In 1966, however, market interest rates rose significantly above the rates thrift institutions were earning on their long-term mortgage portfolios, threatening their solvency. The ceilings on bank rates were allowed to become binding in an attempt to prevent commercial banks from bidding funds away from mortgage lending. To prevent thrift institutions from engaging in a self-destructive bidding war, ceilings were also extended to federally chartered savings and loan institutions and mutual saving banks.

In the short run, this emergency 1966 legislation may have helped to stave off the bankruptcy of some thrifts. However, as the "emergency" ceilings were extended year by year, the artificially low rate of interest on bank and thrift accounts encouraged savers to withdraw their funds from financial intermediaries in favor of other forms of saving. This phenomenon came to be known as disintermediation. Chart 5–1 shows savings deposit inflows at banks and thrifts against the interest rate gap between the ceiling on passbook accounts and market rates. It illustrates the volatility of deposit flows with binding interest rate ceilings in place.

In many ways the effects of the ceilings were the opposite of those intended. For example, the ceilings were intended to ensure a stable flow of mortgage funds. However, they actually led to widespread disintermediation whenever rising market interest rates made other savings vehicles more attractive, so that they effectively destabilized the flow of mortgage money. The ceilings were supposed to make it easier for lower-income families to afford housing by lowering mortgage rates. In fact, the interest rate ceilings advantaged wealthier investors who could meet minimum balance requirements on higher yielding accounts, and who had access to unregulated investments. As a result, the greatest burden of the regulation was borne by small-

Chart 5-1

Savings Deposit Inflows versus the Interest Rate Gap



1/ Change in savings deposits at commercial banks and thrift institutions (seasonally adjusted averages of daily figures).

2/ Ceiling on passbook savings accounts at commercial banks less rate on 3-month Treasury bills (both measured in percent per annum).

Sources: Department of the Treasury and Board of Governors of the Federal Reserve System.

er savers. Moreover there is little evidence to suggest that the rate ceilings were effective in keeping mortgage interest rates down.

Rate ceilings were often effectively circumvented through nonprice competition and through investment in unregulated instruments. Extensive branching, free checking and financial services, expensive promotions, and "free" gifts were among the many forms of implicit interest that banks and saving institutions used to attract customers. As market interest rates rose through the 1970s, the diversion of funds into unregulated instruments led to attempts to "tune" the ceiling structure for different categories of deposits. The number of different accounts subject to ceilings went from 2 in 1965 to 24 by

1979. These attempts to restrain disintermediation were not very successful. A new ceiling-free investment vehicle, the money market mutual fund, became increasingly popular. Balances in these accounts jumped from $6.4 billion in 1978 to $150.9 billion by 1981.

Unintended effects and widespread opportunities for avoiding the ceilings, among other things, led to the passage of the Depository Institutions Deregulation and Monetary Control Act in 1980, which mandated the gradual removal of ceilings by 1986. At the Administration's request the Depository Institutions Deregulation Committee has accelerated the phaseout of rate ceilings. By the end of 1983 fewer than one-fourth of interest-bearing deposits were in rate-restricted accounts.

DEREGULATION AND MONETARY CONTROL

Interest rate ceilings not only provoked bouts of disintermediation, but also damaged the ability of the Federal Reserve to measure and control the money stock. The ceilings also reduced the stability of the link between changes in the monetary aggregates and changes in nominal income, making the task of managing monetary policy more difficult.

When market interest rates rose significantly above ceiling rates, funds flowed out of traditional financial intermediaries, new deposit categories were defined by the regulators, and money market mutual funds emerged to offer deposit-like accounts that were beyond the direct control of the monetary authorities. As a result, market reaction to binding interest rate controls resulted not only in a less predictable environment for making monetary policy, but also in conceptual changes in the definitions of the monetary aggregates.

The 1980 Depository Institutions Deregulation and Monetary Control Act contained provisions that, when full adjustment to them is completed, will significantly improve the potential for accurate Federal Reserve control over the monetary aggregates. For one, the act mandated a phaseout of interest rate ceilings on interest-bearing accounts. The Garn-St Germain Depository Institutions Act of 1982 continued the process by authorizing a new ceiling-free account, the money market deposit account. Both steps should prevent circumstances in which these components of the broader monetary aggregate, M2, become suddenly less attractive than savings vehicles not included in M2. As a result, new episodes of large-scale disintermediation are unlikely to occur.

A proposal currently being discussed, that would go still further in the direction of decontrolling deposit interest rates, would allow banks to pay interest on ordinary demand deposit accounts, and would require the Federal Reserve to pay interest on required reserves held against deposits. The cost of paying interest on reserves could be offset by increasing taxes or charges on institutions subject to reserve requirements. There are good arguments for such a proposal. Paying interest on reserves would eliminate the disadvantage that deposit accounts subject to reserve requirements have in relation to nonreservable accounts, such as money market mutual fund accounts. But perhaps the strongest is that once portfolio adjustments associated with the change are completed, paying interest on deposits and reserves would tend to stabilize M1 velocity—the ratio of gross national product (GNP) to the narrowly defined money stock, M1—and therefore facilitate monetary policy.

One cause of fluctuations in velocity is changes in the opportunity cost of holding money—the difference between market interest rates and interest rates on deposit accounts. Because ordinary demand deposits do not earn interest, the willingness of individuals and businesses to hold deposit balances changes inversely with market interest rates. For example, when market rates rise, depositors may attempt to economize on their holdings of non-interest bearing deposits by acquiring interest-earning assets. In the process, monetary velocity rises; for any given level of GNP, depositors hold less money.

Changes in the velocity of money complicate the job of stabilizing nominal incomes. If interest were paid on both demand deposits and reserves, the spread between the rate that competition would force banks to pay on those deposits and the rate that could be earned on other assets would reflect the resource costs associated with providing transactions services to depositors. As a result, the opportunity cost of holding money would be more stable, and it is likely that this would tend to stabilize M1 velocity.

Another provision in the Depository Institutions Deregulation and Monetary Control Act that has improved the climate for monetary control is the imposition of uniform reserve requirements for most types of accounts. Under the legislation, the Federal Reserve is empowered to set reserve requirements, not only for member banks, but also for nonmember banks and nonbank depository institutions, such as savings and loans, mutual savings banks, and credit unions. The reserve requirements cover all transaction accounts, including negotiable order of withdrawal (NOW), Super-NOW, and other automatic transfer accounts. Uniform reserve requirements are being phased in gradually. The process will be complete in 1987.

When uniform reserve requirements are fully phased in, the link between reserves and transactions balances should be tighter than in the past. Transaction deposits at depository institutions have been subject to widely varying treatment. These institutions have faced different reserve requirements depending on their size, location, and whether they were members of the Federal Reserve System. Some State-chartered institutions have not been subject to any reserve requirements. As deposits have shifted among accounts subject to different reserve requirements, the lending and money-creating capacity of the banking system would change without any change in the supply of reserves. Thus, the relationship between reserves and deposits has been subject to unexpected changes. Uniform reserve requirements will reduce this source of variability, and enhance the ability of the Federal Reserve to control the money stock.

GEOGRAPHICAL AND LINE-OF-BUSINESS RESTRICTIONS ON DEPOSITORY INSTITUTIONS

Depository institutions have historically been subject to a number of Federal and State laws that restrict their entry into new geographical markets and nonbanking lines of business. These laws were generally intended to prevent capital outflows from rural areas into financial centers and to stabilize the banking system. However, there is little evidence that they have served either purpose. Instead, they have impeded the development of integrated financial service companies and resulted in a financial services sector with smaller and more numerous firms than would have otherwise developed. They also have impeded the development of businesses that offer both financial and nonfinancial services, despite possible economies from such a structure.

Technological changes, limited deregulation, and the introduction of bank-like services by securities firms and others have eroded the force of these legal prohibitions and encouraged some expansion and diversification by banking firms. These changes have intensified the debate over further loosening geographical and line-of-business restraints. At issue is whether further deregulation will lead to more efficient and competitive financial services markets or promote concentration, instability, and undesirable trade practices.

GEOGRAPHICAL MARKET REGULATION

A complex set of Federal and State laws governs expansion of depository institutions into new geographical markets. In general, the controlling law depends on the type of institution, whether it is chartered under Federal or State law, and the State in which it is located.

The most cumbersome restrictions are those imposed on commercial banks. With few exceptions, interstate branching is prohibited for banks, whether national or State chartered. Intrastate branching of both national and State banks is controlled by the law of the host

State. Historically, most States have restricted intrastate branching, either by prohibiting it altogether or limiting the number or location of branches (Table 5-2). Some relaxation of these restrictions has occurred, but approximately half the States still place some limitations on intrastate branching. Federal geographical restrictions generally conform to State policies.

TABLE 5-2.—*State restrictions on intrastate branch banking, selected years, 1929-83*

[Number of States]

Classification	1929	1951	1961	1983
Branching prohibited	28	17	16	8
Branching permitted but geographically limited	11	14	15	18
Unlimited branching	9	17	19	24

Sources: American Bankers Association and Board of Governors of the Federal Reserve System.

The restrictions on geographical expansion by State savings and loan associations are similar to those on banks, except that many fewer States limit intrastate branching. There are no statutory limitations, intrastate or interstate, on branching by Federal savings and loan associations. However, the Federal Home Loan Bank Board limits interstate branching except where necessary to rescue failing institutions, and it observes the limitations imposed by the few States that do restrict intrastate branching of State-chartered savings and loans.

States generally enacted geographical restrictions on bank expansion for two reasons. First, it was thought that such restrictions would prevent the outflow of funds from localities into financial centers and thereby increase the availability of loans to farmers and small businesses. Second, the laws were intended to preserve local ownership and management of banks.

There is no evidence that branching limitations do in fact constrain the flow of loanable funds. Interinstitutional and interregional capital markets are so well developed that local deposits are as easily loaned out across the country as across the neighborhood.

Even the effect of these laws in promoting local control is questionable. Depository institutions have been able to circumvent the prohibitions either by using holding companies or by offering only limited services in geographical areas where they cannot establish regular branches. In all but five of the States that impose restrictions on intrastate bank branching, for example, bank holding companies may be used to create a statewide banking system by acquiring multiple charters. The growth in the use of multibank holding companies over the past 20 years, from approximately 50 independent companies holding less than 10 percent of total bank deposits to more than 600 companies with over 57 percent of total bank deposits, is attributable in substantial part to the ease with which they can be used to circumvent intrastate branching limitations.

Until the enactment of the Bank Holding Company Act of 1956, the holding company structure could be used to circumvent interstate as well as intrastate branching prohibitions. Provisions of the act, however, prevent a bank holding company from acquiring more than a small interest in a bank outside the States in which it is already engaged without the approval of the State to be entered.

In 1970 changes to the Bank Holding Company Act permitted most banking-related services to be offered interstate, except for deposit-taking. The 1970 changes also narrowed the definition of "bank" to include only institutions that both accept demand deposits *and* make commercial loans. As a result, bank holding companies and others have been able to establish interstate networks of "nonbank banks," consumer finance companies, mortgage companies, and the like, that escape regulation by either not accepting deposits or not making commercial loans. More recently, the Garn-St Germain Depository Institutions Act of 1982 empowered bank regulatory authorities to permit acquisition of failing institutions across State lines.

These changes, plus recent advances in communications and data processing technologies that appear to have reduced the costs of managing multi-office banks, have led to a substantial increase in the level of interstate banking activity. Of approximately 55,000 offices engaging in banking-related activities, more than 7,800 are now located outside the home State of the parent entity. Even these numbers understate the amount of interstate banking activity because they do not reflect the substantial use of shared interstate automated teller machine networks or the phenomenal growth in the provision of bank-like services by interstate securities firms.

The rapid pace at which *de facto* interstate banking is emerging—despite seemingly substantial legal barriers—is one obvious indication of the strength of the forces for change within the financial services industry. These forces are also manifest in the numerous proposals for changes in both Federal and State law. Three New England States have recently adopted laws that provide for entry by out-of-State banks headquartered in other New England States with similar laws, and similar regional reciprocal entry arrangements are under active consideration in several other areas of the country. Other States have modified their banking laws to permit at least some entry from out-of-State, and the evolutionary movement away from intrastate limitations continues. At the Federal level, a number of legislative proposals are now pending that would reduce Federal restrictions on interstate banking.

If geographical restrictions are relaxed, the number of independent banking entities would almost certainly be reduced. States with unit-banking laws presently have approximately 107 independent banking entities per million residents, compared with 72 for limited branching States and only 20 for States with unrestricted branching. The most credible explanation is that branching restrictions impede access by large banks to deposit accounts and small loan business outside their home territories. Deposit accounts have historically been the lowest cost source of funds for banks, and full-service branches are important in marketing consumer and small business loans. Impeded access has therefore inhibited the growth of large firms and favored smaller firms.

However, geographical market deregulation would probably increase the number of banking offices operating in most communities. "Unit-banking" States, those that prohibit all branching, have approximately 182 commercial bank offices per million residents compared with 243 offices per million residents for other States. Although other factors may contribute to the difference, branching prohibitions are probably a significant reason for the lower ratio of banking offices to population in unit-banking States.

On balance, these two changes should increase competition and benefit consumers. The relevant market for retail deposits and small loan customers is compact—the locality or even the neighborhood. Although geographical market deregulation is likely to decrease the total number of depository institutions nationally, each competitor will compete in more local markets. Moreover, the number of potential entrants into each local market will also increase.

Nor would deregulation eliminate all smaller institutions. A recent study concluded that there are unlikely to be large, if any, economies of scale for most important banking services. The best existing data indicate that the costs of providing traditional banking services reach a minimum for institutions in the $50 million to $100 million asset range. Moreover, it does not appear that most bank customers will pay a premium to bank with interstate firms. The experience in States without intrastate branching restrictions is that many small institutions survive and prosper. In fact, smaller banks and thrifts not only coexist with larger ones, but generally have higher profitability on bank assets. Although some institutions, particularly less well-managed ones, will disappear as separate entities, they will most likely be acquired by more efficiently run organizations that will operate them as branches.

LINE-OF-BUSINESS RESTRICTIONS

Federal law embodies a long-standing policy of separating banking from unrelated lines of commerce. Today, as a general rule, banks may not engage in nonfinancial businesses unrelated to banking, either directly or through subsidiaries, nor may bank holding companies or their affiliates. Similar, though somewhat less stringent, prohibitions apply to savings and loan associations and holding companies controlling two or more savings and loan charters. Holding companies that control a single savings and loan association or any number of "nonbank" banks, however, are not subject to Federal line-of-business limitations.

The line separating commercial banking from other financial services is much less distinct. Until the 1930s, State and national banks regularly engaged in underwriting and dealing in securities, often circumventing legal prohibitions by pursuing such activities through affiliated companies. Because of the popular belief that banks had contributed to the Great Crash by promoting speculative securities and unloading worthless issues into trust and customer accounts, the Banking Act of 1933 (the Glass-Steagall Act) was passed. Provisions of the act attempted to divorce banking and the securities industry by barring banks from underwriting or dealing in nonbank securities, whether debt or equity.

The Glass-Steagall separation is incomplete in a number of ways. First, the act's prohibitions against the affiliation of banks with securities firms apply only to banks that are members of the Federal Reserve System, and not to the many State-chartered nonmembers. All banks, however, are prohibited from underwriting securities directly, and securities firms may not take deposits. Second, Glass-Steagall allows all banks to distribute and trade in general obligation government securities. Third, the act authorizes banks to buy and sell any securities for the account of bank customers, provided that such transactions are "without recourse" against the bank.

Until recently, the gaps in the Glass-Steagall Act, except those permitting trading in government securities, were inconsequential. Banks did not aggressively pursue brokerage business because regulatory restraints made it unprofitable. In January 1983 these restraints were relaxed, and as a result thousands of depository institutions now engage in securities brokering.

ECONOMIC ISSUES IN LINE-OF-BUSINESS DEREGULATION

Proposals to ease line-of-business restrictions on depository institutions have spurred much debate. Proponents argue that economic efficiency would be increased by permitting these institutions to underwrite and deal in securities and by expanding their power to engage in collateral lines of business such as insurance underwriting and sales, real estate development, and management consulting. Opponents argue that these changes would increase the riskiness of banking, result in unacceptable concentrations of market power, lead to self-dealing and conflict-of-interest abuses by banking firms, and be unfair to bank competitors.

Product-line deregulation may promote economic efficiency in two ways. First, it may reduce the total cost of providing multiple services by consolidating their provision within a firm. Such savings can result from spreading fixed costs over more activities, improving communications, and effecting synergies in production. Second, customers may benefit from the extra convenience associated with conducting their business with a single firm.

The magnitude of the economic benefits from relaxing line-of-business restrictions is uncertain. Specific cost data for depository institutions and their customers are limited, and reliable estimates of the cost savings from product line deregulation do not exist. Over the past several years, however, several large firms have integrated over a broad spectrum of businesses, including insurance, real estate, and securities underwriting and brokering. Although it is too early to assess the economic success of these ventures, their development is evidence that the market believes that substantial economies from the integration of these businesses are possible. Indeed, much of the pressure for reconsidering line-of-business restrictions on banks has come from members of the banking community who argue that relaxation of these restrictions is necessary for them to meet competition from nonbanking firms offering integrated services.

Product line diversification does, however, raise issues of some concern regarding banking stability. The existence of Federal deposit insurance gives insured institutions an incentive to take undue risks in the hope of earning greater than normal returns. Accordingly, much of the supervisory efforts of banking regulators is directed at preventing excessively risky banking practices. As a practical matter, as the range of business activities increases, it may become much more difficult for regulators to thwart excessive risk-taking.

The Administration's proposed legislation, the Financial Institutions Deregulation Act, strikes a balance by easing restrictions on nonbanking activities but requiring that they be conducted only by separate corporate affiliates that are not bank subsidiaries. This approach has two significant advantages. First, by removing nonbanking activities to affiliates, the bank itself can be regulated and supervised on the basis of the traditional methods developed by the regulatory agencies over many years. Second, because the affiliates are to be subsidiaries of the holding company rather than of the bank itself, the bank would be insulated from any financial problems that occur in the subsidiary.

There is, of course, no way to guarantee that difficulties in an affiliate will not affect the bank. But with proper safeguards the problems can be minimized. Moreover, it is important to recognize that attempts to seal off banking from collateral activities is a recipe for an endless expansion of regulation. Brokerage firms are now expanding bank-like activities rapidly. Extending regulation to these bank competitors would simply push regulatory avoidance to another channel. There is, in addition, far more danger of financial instability from unregulated banking substitutes than from properly supervised banks permitted to expand their powers within well-designed corporate structures.

A similar point may be made with respect to predictions that increases in self-dealing and conflicts of interest will result from repeal of Glass-Steagall. The potential for these abuses is already present in both commercial and investment banking. For example, broker-dealers already represent both purchasers and sellers, deal for their own account, provide investment advice, manage mutual funds, and act as fiduciaries with respect to trust or discretionary accounts. Bank trust departments may transact in the securities of bank customers.

In fact, legal and market forces have limited self-dealing and conflict-of-interest abuses. Legal standards governing fiduciary behavior are strict, and the conduct of fiduciaries is subject to regulation. In addition to legal mechanisms, market forces are extremely important. Systematic abuses by a bank's trust department would, for example, reduce the return on the portfolios it manages, causing it to lose business to competitors. Although one cannot say that no such abuses will occur, existing controls should keep them to a minimum.

Line-of-business deregulation also poses issues of fairness. Opponents of changes to existing law have argued that depository institutions could operate collateral lines of business with low-cost capital, benefiting from access to the Federal Reserve's discount window, and an implicit subsidy from Federal deposit insurance. They charge, for example, that some industrial companies and retailers have acquired a deposit-taking "nonbank" bank or a single savings and loan association to finance their own activities or customer purchases of their products and services with low-cost capital.

This argument ignores the fact that the profitability of a consolidated enterprise cannot be increased by charging an affiliated business or customer a submarket rate of interest. Any attempt to do so will reduce the profitability of the bank, leaving the earnings of the enterprise unchanged. In other words, if a bank has access to low-cost capital, it will be profitable to its owner even if the bank provides no financing whatsoever for the parent company or its customers. As long as the capital market is competitive, the cost-of-funds differential between financing customers from bank deposits on the one hand and from selling commercial paper on the other will only be enough to cover the costs of operating the bank and to earn the going rate of return on the assets invested in the bank.

Another argument is that financial intermediaries would be able to compete unfairly by tying loans to the purchase of other services. It is not likely, however, that many financial intermediaries would find tying arrangements advantageous. Tying arrangements are a way in which a firm with market power can circumvent laws against price discrimination and increase its profits by selling different customers different quantities of tied-in products. It is unlikely that many banks have such market power, but even if some do, they could directly price discriminate by charging different interest rates to different customers.

Banking organizations, however, enjoy certain regulatory and tax advantages over nonbank competitors, particularly securities firms. Banks are largely exempt from regulation under Federal and State securities laws and, therefore, could enjoy a cost advantage in broker-dealer, underwriting, and investment management activities. Moreover, in determining taxable income depository firms may deduct interest paid on deposits, even if they are used to finance holdings of tax-free securities. This provision of the tax law may give them an advantage in carrying inventories of securities relative to nonbank securities dealers.

The problem of asymmetrical tax and regulatory treatment could be solved, either by modifying tax and securities laws or by allowing only affiliated entities to undertake such activities. The latter approach has been adopted in the Administration's Financial Institutions Deregulation Act. Under this act affiliated entities would not be exempt from the securities laws, nor be subject to favorable tax treatment.

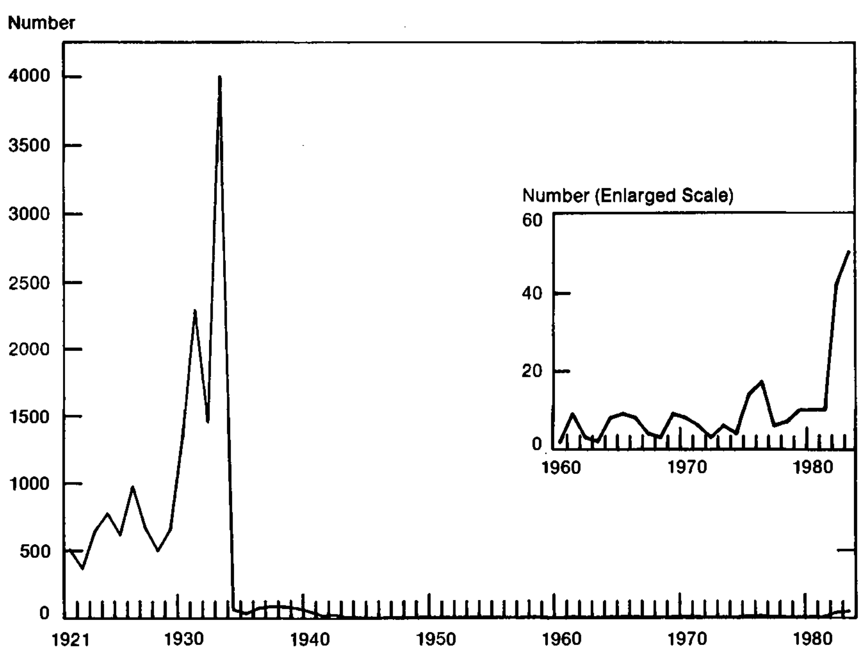
DEPOSIT INSURANCE REFORM

In today's financial market, the traditional depository institutions, commercial banks, and thrifts compete with money market mutual funds and brokerage firms in offering highly liquid deposit accounts that pay competitive rates of interest. Commercial banks and thrifts, however, retain a unique position relative to their newer competitors, because their liabilities are federally insured. The system of Federal deposit insurance was created as part of the Banking Act of 1933. Under this law the Federal Deposit Insurance Corporation (FDIC) insures deposit accounts for banks that are members of the corporation. A year later the Federal Savings and Loan Insurance Corporation (FSLIC) was established to provide a similar arrangement for the savings and loan industry.

The purpose of the FDIC was to eliminate the financial panics and bank runs that had long plagued the economy, one of which culminated in the collapse of the banking system in 1933. Measured by that criterion, deposit insurance has been tremendously successful. There is wide agreement that earlier problems with financial market instability were not solved by creating a national currency, nor by imposing reserve requirements on banks, nor by the establishment of the Federal Reserve System, but by deposit insurance. Chart 5-2 illustrates the dramatic decline in bank failures after the FDIC was established.

Chart 5-2

Bank Failures



Note.—Data for 1983 estimated.

Sources: Comptroller of the Currency and Federal Deposit Insurance Corporation.

The volume of deposits insured by the FDIC and FSLIC has increased greatly in recent years as coverage limits have been raised and as new insured accounts have been introduced. Since 1950, the limits have increased at faster rates than inflation, and now stand at $100,000 per depositor. The introduction of money market deposit accounts in mid-December 1982 and ceiling-free Super-NOW accounts in January 1983, and the elimination of ceilings on most small time deposit accounts in October 1983 have also produced increases in the amount of insured deposits, as many customers have switched out of the uninsured accounts issued by money market mutual funds into the insured deposit accounts issued by banks and thrifts.

Federal deposit insurance gives banks, savings and loans, and credit unions an advantage in the competition for funds, and alters the structure of incentives in the industry. To some extent these advantages have been offset by competition-inhibiting restrictions on the amount of interest payable on deposit accounts, on allowable activities, and on opportunities for expansion into new markets. In recent years, deregulation and private market innovation have eliminated or reduced the force of many of these restrictions on competition, thereby increasing efficiency in the industry. However, the FDIC and the Federal Home Loan Bank Board, the parent of FSLIC, have argued that their ability to control risk-taking by institutions offering insured accounts has been impaired in the new environment. As a result, the deposit insurance system is currently being reassessed.

Because most of the expansion in the range of opportunities available to insured depository institutions has taken place only recently, conclusive evidence on the effect of these changes on failure rates of insured institutions and the dollar magnitude of actual payouts is difficult to determine. There has been a large increase in the number of failures in recent years. But this increase can be attributed primarily to the depth of the recent recession, which has exacerbated problems associated with insufficient diversification and mismatches between asset and liability maturity structures at some institutions that have long existed.

Nevertheless, changes in the risk characteristics of financial institutions that are taking place now may have a significant effect on failure rates in the future. In addition, financial institutions are still refining their strategies and tactics in the new financial environment, and so further changes in market practices can be expected.

THE IMPACT OF DEPOSIT INSURANCE

If deposit insurance were unavailable, depositors would have incentives to evaluate the riskiness of a depository institution's balance sheet and policies, because their deposits would be at risk. The existence of these incentives, and competition among intermediaries for funds, would impose strong discipline on managers to adopt sound portfolio policies. One obvious consequence of insuring deposits is that the incentives of insured depositors to evaluate risk are eliminated, so that market discipline is greatly diminished. As a result, it is up to the insurer either to design an insurance system that provides the correct incentives for the intermediaries or to impose restrictions on intermediaries that limit possibilities for excessive risk-taking.

Currently, the premiums charged by the FDIC and FSLIC are proportional to the amount of assessable deposits regardless of the riskiness of the intermediary's assets. Under this system, insured institutions have an incentive to take on more risk than they would otherwise, either by making riskier loans or by increasing leverage. Doing so does not subject them to higher premiums, and they obtain the benefits of the higher yields that normally accompany the assumption of greater risk.

With premiums unrelated to risk, therefore, regulation of insured intermediaries is justified. It is not coincidental that many restrictions on competition accompanied the introduction of deposit insurance in the Banking Act of 1933. In fact, the primary thrust of financial legislation through the 1930s, much of which is still in place, was to supplant or limit competition in the market for financial services, both to prevent bank failures and to protect the assets of the insuring agencies.

The undesirable consequences associated with many of these restrictions have already been discussed. To some extent the restrictions have simply redirected competition into other areas, some of which are socially wasteful, and have caused the industry to evolve in a less efficient manner than it otherwise would have. Moreover, to the extent that competition has been limited, the restrictions have served to reduce incentives to lower costs, and therefore prices. Reform must focus on incentives for limiting risk, rather than on restrictions on competition.

PROPOSALS FOR REFORM

Many proposals have been advanced to strengthen private incentives to control risk-taking by institutions offering insured accounts. The proposals can be grouped into the following categories:

- Tie insurance premiums to some measure of risk.
- Strengthen capital requirements.
- Increase the risk exposure of large depositors.
- Strengthen disclosure requirements.
- Privatize all or part of the deposit insurance system.

It appears that none of these proposals, taken alone, offers a completely satisfactory solution, but a combination could accomplish the goal of strengthening private incentives to control risk-taking, while preserving stability of the financial system.

Relate Insurance Premiums to Risk

Charging insurance premiums that reflect the riskiness of an institution's balance sheet and management capabilities is a solution with great theoretical appeal. If the premium paid to the insurer were actuarily fair, in the sense of covering the expected losses of the insurer given the risk and capital of the firm and the terms of the insurance contract, the incentive to take on additional risk at the expense of the insuring agency would disappear. This approach would seem to obviate the need for extensive regulatory constraints. Insured institutions would be free to structure their assets and liabilities and to compete in the financial marketplace on terms of their own choosing. Those electing to adopt aggressive strategies with respect to risk and return would simply pay higher premiums to compensate the insurer for their higher expected claims.

There are problems with risk-related premiums, however, stemming from the difficulties associated with measuring risk properly and determining an appropriate schedule of premiums. One important measurement problem arises from the role that diversification plays in reducing risk. The riskiness of a portfolio cannot be evaluated simply by examining the riskiness of individual assets. Portfolio risk depends more on the interrelationships among the assets and how they match up with the structure of liabilities.

Banks and thrifts have traditionally faced different types of portfolio risks. This is reflected in the experiences of failed or troubled institutions in these two industries. A major cause of bank problems and failures has been insufficient diversification. For example, many of the banks that have recently failed, or are now experiencing difficulties, had heavily invested in real estate loans, loans to the oil and gas industry, or to foreign borrowers. For savings and loans the principal problem has been excessive exposure to interest rate risk—the result of borrowing short, by accepting deposits either payable on demand or with comparatively short duration, and lending long, by writing long-term, fixed-rate mortgages. Until recently, savings and loans were subject to regulatory and tax provisions that encouraged them to accept substantial interest rate risk, since the provisions provided strong incentives to invest in long-term fixed-rate mortgages and since they were prohibited from reducing their exposure by other means.

In principle it is possible to quantify certain types of risk, for example, interest rate risk, provided that complete enough balance sheet information is available. However, other types of portfolio risks are more difficult to assess objectively. The bank examination process, though important, contains subjective elements that make it unsuitable as an exclusive basis for setting premiums.

For these reasons, sole reliance on risk-based insurance premiums is impracticable. However, risk-based premiums may play a useful role as part of a package of reforms designed to deter excessive risk-taking. To implement a risk-based system, the elements of risk that are measured must be clearly related to failure, and the premium structure must not create perverse incentives for institutions to assume other risks that are not used as a basis for premiums. Given the limited present ability to meet these criteria, premium differentials across risk categories should probably be kept small, at least initially.

Strengthen Capital Requirements

Ratios of deposits to bank capital for the banking and thrift industries have increased steadily over the past 30 years. Under the present policy for pricing insurance, it may be advantageous for owners of insured intermediaries to drive these ratios to very high levels, unless other restrictions are in place. Strengthening capital requirements would be advantageous for two reasons. First, the additional capital would directly provide an extra margin of safety both for the insuring agencies and uninsured depositors. Second, by placing more of an intermediary's own capital at risk, incentives to control risk-taking would be strengthened.

It may be desirable to allow strengthened capital requirements to be satisfied either through the issuance of new equity or subordinated debt—bonds whose claim on bank assets is subordinate to the claims of depositors and the insuring agencies, but prior to the claims of equity holders. Bondholders would be another class of investors with incentives to monitor an intermediary's practices.

Proposals that rely solely on strengthened capital requirements without any other reforms have some serious drawbacks. For one, the question of the appropriate level of capital should not be addressed apart from the riskiness of the rest of an institution's portfolio—two institutions with identical ratios of deposits to capital can represent very different risks to the insuring agency. There are also problems with properly measuring net worth. Large discrepancies can exist between true and accounting values of assets and liabilities. The measure of true net worth that many prefer—the market's estimate—is generally not available since the majority of financial institutions are not publicly held. Further, the market value of banks that are publicly traded may reflect the guarantees that are implicit in deposit insurance.

Increase the Risk Exposure of Large Depositors

Many observers have argued that any reform of the deposit insurance system should include provisions that would increase the risk exposure of large depositors as a way of imposing greater market discipline. Insured depositors presently have little or no incentive to evaluate the soundness of an intermediary. If virtually all depositors are effectively insured, the discipline of the market that would come from private sector scrutiny of the intermediary's policies is lost. The existence of ceilings on the amount of insured deposits in any given account suggests that some large depositors are at risk, so that intermediaries competing for their business would be subject to private sector scrutiny. However, this discipline has not been important in recent years.

The reasons for the current lack of market discipline differ somewhat for savings and loans and commercial banks. Savings and loans have few uninsured deposits—fewer than 4 percent of total deposits at the end of 1982. In contrast many banks have sizable uninsured deposits. The FDIC has estimated that as of June 1983 approximately 27 percent of all domestic deposits in commercial banks were uninsured. For large banks with more than $10 billion in deposits the figure is approximately 40 percent, and for the largest money center banks the figure approaches 80 percent. However, particularly for medium- and large-sized banks, the FDIC's procedure for handling failures—which involves arranging a merger with a sound bank while covering the failed bank's losses—has meant that few uninsured depositors have suffered losses. Since the establishment of the FDIC, no depositor has ever incurred a loss as a result of a failure of a member bank with more than $1 billion in total deposits.

A recent FDIC report submitted to the Congress on the subject of deposit insurance reform stresses the importance of restoring the perception that large depositors are at risk, possibly by abandoning the policy of arranging mergers. However, as recently as October 1983, the FDIC provided *de facto* insurance for uninsured depositors at a large bank by arranging a merger. The FDIC appears to face a classic problem in its management of bank failures: it would like to represent itself as being willing to permit uninsured depositors to suffer losses so as to restore private incentives to monitor risk, but for any given failure the FDIC often finds it cheaper to assume the losses in the process of arranging a merger. Moreover, under present arrangements, doing otherwise might require a lengthy bankruptcy proceeding perhaps lasting years and tying up billions of dollars of assets and deposits. If the institution were large, this could be highly disruptive.

One factor complicating the task of increasing the risk exposure of large depositors is the emergence of the deposit brokerage industry. In recent years a network of brokers has emerged to parcel large deposits into insurable increments and place them in financial institutions nationwide. Deposit brokers perform the useful function of facilitating interregional flows of funds. However, they also have been known to place insured funds in banks without any credit analysis, or worse yet, place them in known problem banks in order to collect higher fees. In an attempt to check this type of activity, both the FDIC and FSLIC have recently announced that problem institutions would be subject to limitations on the amount of brokered deposits they could accept.

A common prescription for increasing market discipline is to lower the limits on insured accounts. However, the emergence of the deposit brokerage industry suggests that unless the limits are lowered very substantially, the impact may be slight. A more promising way to accomplish large reductions in the coverage levels, and at the same time protect small depositors, would be to return to the fractional coverage scheme that was a part of the original Federal deposit insurance legislation. The act President Roosevelt signed into law called for full coverage of the first $10,000 of a deposit, 75 percent coverage of the amounts between $10,000 and $50,000, and 50 percent coverage for amounts above $50,000. This plan never took effect, as a temporary plan adopted by the Congress was extended indefinitely. A partial coverage plan of this type is in effect in the United Kingdom, where 75 percent of deposits in failed banks are reimbursed up to a ceiling amount.

There is one significant advantage of a fractional coverage system. When a failure takes place, depositors maintaining funds above the ceiling amount for full coverage could receive immediate payment up to the amount of their coverage. Additional amounts could be paid later, depending on what is realized from the failed institution's portfolio. As a result, the disruptive effects on the payments system that could be associated with the liquidation of a large institution's portfolio would be minimized.

There is, however, an important tradeoff associated with implementing a fractional coverage system. In order for market discipline to be a credible deterrent to excessive risk-taking by financial intermediaries, uninsured depositors must be prepared to move funds out of troubled institutions. Exposing large depositors to greater risk, therefore, increases the likelihood of deposit flight from those institutions. Because deposits can be moved quickly and cheaply to a new institution, such a system might mean that an intermediary subject to moderate but well-reported problems would experience deposit outflows that could prevent its recovery. The recent expansion of access to the Federal Reserve discount window to both nonmember banks and thrift institutions should be important in preventing unwarranted deposit flights from causing the failure of marginal institutions.

Improve Disclosure

Any proposal that relies heavily on increased market discipline should be accompanied by improved disclosure and strengthened reporting requirements. Federal bank regulators have not required insured institutions to carry assets and liabilities on their balance sheets at market value, or until recently to report financial information that would permit an assessment of the interest rate risk and credit risk to which an institution is exposed. However, the Securities and Exchange Commission does now require bank holding companies to report some market value data and data that could lead to an assessment of interest rate and credit risk.

Privatize Deposit Insurance

The provision of deposit insurance is now a virtual Federal monopoly. Consequently, it is impossible to use market measures to assess the performance of the FDIC and FSLIC in setting premiums, either under the current system or under a new system with variable premiums. Further, if incorrect assessments were applied under a system of risk-related premiums, the insured institutions might have few other sources of insurance. In principle, a private market for deposit insurance would seem to avoid these problems; market forces could be relied upon to guarantee that intermediaries were evaluated fairly. In addition, private insurers would have an incentive to share many of the costs of monitoring their behavior. Privatizing deposit insurance might, therefore, be another means of bringing the discipline of the market to bear on financial institutions.

It may be possible to introduce some elements of a joint public-private deposit insurance system. There is already some private participation in the market for financial guarantees. For example, at least one major money market mutual fund has obtained private insurance for its shareholders, and private insurance of mortgages and credit union deposits is well established.

It is not likely, however, that responsibility for insuring deposits can be shifted to any great extent to the private sector. Some ultimate Federal guarantee may be necessary to maintain public confidence. In addition deposit insurance was established primarily to protect against the risk of a banking crisis—the prospect of many bank failures occurring simultaneously. It is precisely this kind of risk that the private insurance industry is least equipped to handle.

SUMMARY

The benefits of a credible deposit insurance system should be achievable in an environment with fewer restrictions than the present one, provided certain basic reforms are implemented. A deposit insurance system tied to risk would be a significant reform. Strengthened capital requirements, the introduction of fractional coverage for relatively large accounts, and improved disclosure should also play roles. A deposit insurance system relying more heavily on incentives of this kind can be expected to involve significantly lower net costs than restrictions on entry, activities, and the pricing of financial services that serve either to limit competitive pressures in the marketplace, or to redirect competition into other areas.

REFORM OF THE REGULATORY STRUCTURE

Today the regulatory structure is characterized by considerable overlap and duplication of function among numerous Federal and State authorities. In December 1982 the Administration announced the creation of the Task Group on Regulation of Financial Services, chaired by the Vice President to study Federal regulation of financial institutions and to develop proposals for comprehensive reform. A principal objective of the Task Group has been to address the overlap and duplication in Federal banking regulation.

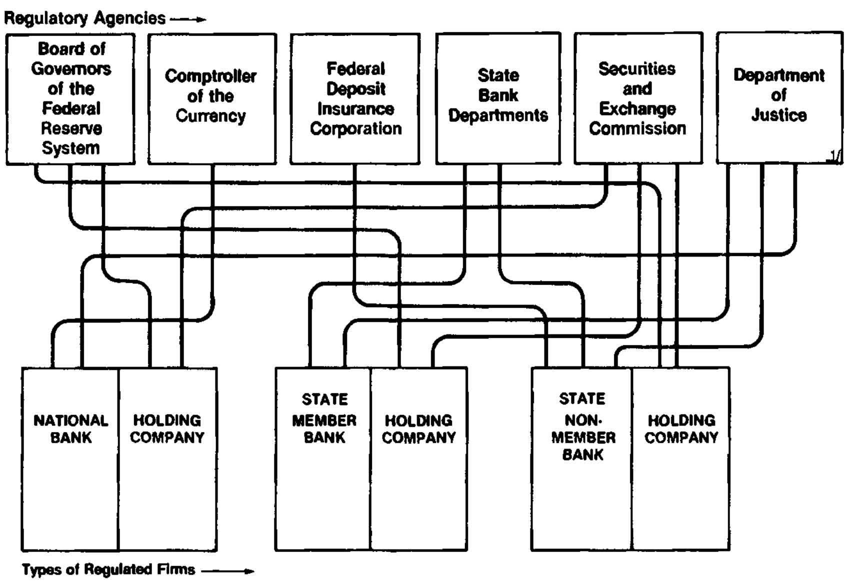
The regulatory structure for depository institutions developed in a piecemeal fashion over many decades. Until the Civil War, all banking activities, with only minor exceptions, were conducted by State-chartered institutions. Between 1863 and 1865 the Congress enacted legislation that was designed to force State banks to recharter under Federal law. State-chartered banks did not disappear, however, largely because State bank regulations were often less stringent than Federal regulations. Hence a dual banking system developed, in which banks could operate with either a Federal or State charter, under the jurisdiction of separate regulatory authorities. This aspect of the regulatory structure for banking, and more recently thrifts, has played an important role in shaping the industry. It has fostered innovation by permitting many possible paths of evolution instead of one. Two important examples of innovations first permitted by State regulators are branch banking and NOW accounts.

Successive layers of Federal regulation of commercial banks were applied in response to financial crises and the emergence of new institutions and forms of organization. A bank today can hold a national charter, in which case it is supervised by the Comptroller of the Currency, or a State charter. All nationally chartered banks are also members of the Federal Reserve System, but State-chartered banks can be either members, in which case they are regulated by the Federal Reserve Board, or nonmembers, in which case they are regulated by the FDIC. However, holding companies of both national banks and State nonmember banks also fall under the jurisdiction of the Federal Reserve. Because of tax, regulatory, and financing advantages, the holding company form of organization has become dominant. As a result, the Federal Reserve has at least some jurisdiction over the majority of commercial banking entities, particularly the larger ones. Although Federal deposit insurance is not mandatory for State-chartered banks, virtually all commercial banks are members of the FDIC, and so come under its jurisdiction as well. Chart 5-3 illustrates the complexity of current arrangements.

Chart 5-3

Existing Regulation of Banks and Their Holding Companies

December 31, 1983



1/ Antitrust enforcement only.

Source: Vice President's Task Group on Regulation of Financial Services.

Because several agencies typically share responsibility for regulating a particular bank, and because different banks are regulated by different agencies, depending on their charter and form of organization, gaps and overlaps of regulatory power among the many agencies have developed. In addition, these agencies have sometimes had conflicting objectives and motivations in dealing with regulatory issues. For example, the Federal Reserve has traditionally exerted a conservative influence, while the chartering agencies at both the Federal and State levels have been more inclined to encourage growth and development.

An advantage of the regulatory structure for the savings and loan industry is that the problems of duplication of effort and gaps and overlaps of authority are much less pronounced, since the FHLBB performs the functions that three separate Federal agencies—the Federal Reserve, the Comptroller of the Currency, and the FDIC—now perform for commercial banks. Of course, if federally insured, a State-chartered savings and loan association is regulated by both FSLIC and its State-chartering agency.

In the 1930s when separate regulatory structures were established for commercial banks, thrifts, and securities dealers, those firms comprised distinct industries with little competition across industry lines. Because of differences in the products and services offered (for example, between brokerage houses and commercial banks), or between customer groups (for example, commercial borrowers using commercial banks and small savers and home buyers using savings and loan associations), regulatory decisions applying to those industries could be made independently. Consequently, there was, at first, little reason to consider reform of the regulatory structure.

In recent years the lending and investment powers of thrift institutions have been broadened as a result of both Federal and State legislation. As a result of these new powers, thrift institutions may now engage, with some limitations, in virtually all the activities that are lawful for commercial banks. This new state of affairs has highlighted differences in their regulation and supervision. For example, it is now legally possible for a thrift institution to become functionally equivalent to a commercial bank, while remaining eligible for regulatory programs designed to create incentives for traditional thrift activities.

In addition, banks and thrifts now face aggressive new competition from brokerage firms, money market mutual funds, and "nonbank" banks in their traditional markets. At the same time, technological change, notably computer-based accounting and communication, has opened up opportunities for substantial increases in the scope of business across a broadening range of products and customer groups. As a result, there has been renewed interest in reforms that would produce a level playing field on which the various providers of financial services could compete on equal terms, and that would permit emerging economies in the provision of financial services to be exploited to the fullest extent possible.

The long-standing opportunities banks have had for selecting a charter and form of organization that places them under different primary regulators, and the growing similarities in the legal powers of banks and thrifts, have implications for the behavior of the regulatory agencies. The various regulatory agencies must offer sufficiently attractive terms to institutions operating under their charters to maintain their existing clientele bases and to attract new firms. There are different opinions as to whether this situation is desirable. One view is that the present scheme leads to "competition in laxity" and therefore insufficient restraints on unsound practices. Another view is that it tends to eliminate the most onerous regulatory strictures, and fosters innovation and efficiency.

Because of the enormous changes that have occurred in financial markets in recent years, the regulatory structure has become progressively out of date. As a result the case for regulatory reform is now very strong. The Administration's Task Group on Regulation of Financial Services is expected to issue its report in early 1984. The report will focus debate and attention on a specific set of legislative proposals to streamline Federal regulation and reduce the overlap between Federal and State regulators.

CONCLUSIONS

Of all the goals of financial regulation the goal of financial stability is paramount. In the 1930s, financial instability was widely attributed to the natural operation of competitive markets, and this view supported a very substantial extension of regulatory controls over financial markets. More recently, however, a renewed respect for the efficiency of competitive markets has developed, as well as increased recognition of the costs of regulation. Regulation tends to spread in unproductive directions and often causes industries to evolve less efficiently than they otherwise would. For these reasons, the promotion of efficiency by furthering competition is also an important regulatory goal. The purpose of regulation should not be to protect poorly managed individual firms from failure, but rather to prevent such failures from shaking the stability of the financial system as a whole. Regulations should be designed to achieve stability of the system, while individual firms are afforded the maximum possible freedom to compete and innovate.