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The history of banking and of the regulations of the banking industry

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PREFACE

Throughout history, the United States economy has undergone periods of regulation followed by periods of deregulation. Within the past decade we have witnessed deregulation in the airline industry, the trucking industry, the railroad industry and perhaps most recently the deregulation of the financial industry. The deregulation of the financial industry in the form of the DEPOSITORY INSTITUTIONS DEREGULATION AND MONETARY CONTROL ACT OF 1980 and the GARN-ST. GERMAIN DEPOSITORY INSTITUTION ACT OF 1982 have been considered landmark legislations in this, the period of deregulation. The reason for such importance being placed on these two particular pieces of legislation is due to the fact that financial institutions have traditionally been heavily regulated and controlled by the government. It is therefore very important to study the deregulation of financial institutions because of the potential impact that it could have on the financial service industry and on the economy as a whole.

CHAPTER ONE
THE HISTORY OF BANKING AND OF THE REGULATIONS
OF THE BANKING INDUSTRY

Banks serve two basic functions within the United States economy. The first of these functions is the function as a store for savings. In other words, it is a place to keep money and other tangible assets. The second function is the use of banks for transactional purposes. The concept of banks being protected is perhaps as old as banking itself. Banking regulation serves to protect depositors and the depositor insurance fund. Regulations also serve as a means of stability and as protection for bank customers from the monopoly powers of banks.

Traditional forms of regulation include regulations on interest rates, geographic regulation and product specialization regulation. Three agencies are responsible for overseeing banking and other financial institutions activities. These agencies are the FEDERAL DEPOSIT INSURANCE CORPORATION (F. D. I. C.) the COMPTROLLER OF CURRENCY, and the FEDERAL RESERVE.

The FDIC is responsible for entry requirements, bank examinations, deposit rates and the disposition of failed or failing banks. Like the FDIC the Comptroller of currency has the authority over exit and entry requirements. In addition they have control of the banking factors. Banking factors are the banks income, expenses and capital management. They also have authority over the market factors. Market factors are economic conditions that exist. These conditions include growth potential, market share and examinations. The Federal Reserve system is concerned primarily with the implementation and

formulation of monetary policy. As the central bank it is in charge of examining state member banks. The Fed is also given authority over bank holding companies. The Fed is also responsible in part for setting the reserve requirements that banks must abide by. The final function the Fed has is the lender of last resort. This function provides liquidity for banks that are short on cash by offering money through its discount window.

As mentioned previously, financial institutions are regulated on three main fields: geographic, interest rate, product specialization. Geographic restrictions within the banking industry are primarily the focus of the McFadden Act of 1927. The McFadden Act's main thrust is its stand on branching activities. The act states that banks are limited to branch only within states, and then this intrastate branching was to be regulated by the individual states. In intrastate branching there are three main categories. These categories are limited branching, unlimited branching and state wide branching. The meanings to this is considered self explanatory. The Douglas Amendment to the McFadden Act stated that a bank or bank holding company in one state, could not acquire a bank in another state. This amendment closed one of the loop-holes of early interstate banking. A second act concerned with geographic restrictions is the Bank Holding Company Act of 1956. This act defined a bank holding company as a company that owned two or more banks. In addition the act gave responsibility of Bank holding companies to the board of governors. The board was given responsibility for

the following:

- Approval for Bank Holding Companies
- Approval for banks being acquired by BHC
- determination of permissible non banking activities for BHCs
- Approval for non-banks acquired by BHCs
- Regulation of foreign banks and non-bank affiliates of BHCs
- Supervision of holding companies and subsidiaries
- Restrictions between banking and non-banking affiliates

Geographic restriction were also part of the focus of the Federal Deposit Insurance Act. This act provided for the speedy liquidation of failed banks and the protection of deposits of small savers against losses due to failures. This act also created the Federal Deposit Insurance Corporation. In addition to the functions of the FDIC, that were mentioned earlier, the FDIC also insures depositors up to \$100,000 for their deposits. In the field of product specialization, the Glass-Steagall Act is the legislation that hampers diversification into such activities as underwriting and investment banking.

The Glass-Steagall act was adopted in response to the stock market crash, the depression and the banking crisis. The Glass-Steagall act provides for Federal Deposit Insurance, strengthening the federal reserve system, expanding branch banking and four provisions that mandated a substantial separation of commercial and investment banking.

Although there appears to be a great deal of legislation that

would prevent banks and other financial institutions from working around the law this is not the case. In order to get many of the legislations passed it was necessary for Congress to make concessions. Congress could not make the laws as inclusive as they had originally wanted and this provided for a number of loop-holes. It is these loop-holes that allow banks to operate seemingly with no regard to legislation. One of the major loop-holes is that of a non-bank bank. A non-bank bank is an institution that doesn't offer the full services of a bank. A bank is defined as an institution that takes deposits, provides checking deposits, provides commercial and consumer loans. Therefore if any of the above components of the definition of the bank is missing the bank is considered a non-bank bank. Therefore if an institution wants to circumvent the banking legislation it can eliminate one of the components of the definition. An institution can then for example, buy a bank across state lines and eliminate the function of taking deposits. This would be in effect opening a branch across state lines. Another way to circumvent branching legislation is to use a reciprocal agreement. In this type of agreement one state decides to let another state operate within it if the agreement is reciprocated. Other ways to circumvent branching or geographic legislation are through the use of grand father clauses and rescue operations.

A rescue operation is used when no bank within the state is willing to merge. The government will seek bidders from out of the state to buy a failing institution. An operation was

attempted like this when Continental Bank of Illinois was experiencing difficulties in the early 1980's. A grand father clause is used when banks were performing activities that were legal and then became illegal. The government allows these institutions to continue those activities. There is so much dodging of geographic regulation because of the proposed benefits from branch banking. Branch banking is assumed to have the following advantages as seen by bankers:

- Service of the customer will improve
- Risk would be more diversified
- Increased capital
- Better Management
- Interest rates would be more uniform across states
- Banks could achieve economies of scale
- Banks could utilize centralized advertising

Geographic restrictions are not the only restrictions that can be circumvented. Product specialization regulations also have loop-holes that can be taken advantage of. A BHC can own several non-bank banks that can offer quite a comprehensive service. The best example of this is CitiCorp. CitiCorp owns several non-bank banks that offer a variety of services. They have a corporate banking division which offers commercial loans. In addition they have a consumer division that offers consumer loans. The following is a laundry list of services that CitiCorp is allowed to offer because each division is a separate entity and thus considered a non-bank bank: Mortgage banking, Investment Banking, Credit Card Data Processing, Airport Currency and National Student Loans. As you can see current banking legislation offers many back doors.

The previous list of historical regulation of course is not an exhaustive one. There are countless pages of bank legislation and regulation. The legislations that I discussed though, are important to this paper because they are the legislations that were either deregulated in the 1980 and 1982 legislation or that are considered the new battle ground for future legislation. It was important for me to establish a base on both historical legislation and means of circumventing it for two reasons:

1. The fields that have historically been regulated are the fields that are now being deregulated or are being discussed for future deregulation or reform.
2. The fact that the historical legislations were being circumvented to such an extent lead to the appeals court ruling that current banking laws had become antiquated and they were due for a major rehaul.

The remainder of this paper will deal with the environment which lead to deregulation, the two fore runners of bank deregulation (DIDMCA and Garn-St. Germain) and their provisions and expectations, the effects of deregulation after the final phase was complete and finally reform and legislation since 1982 and possible future reform and regulation.

CHAPTER TWO
ATMOSPHERE PRIOR TO INITIAL DEREGULATION

As with any form of regulation or deregulation there are forces operating that bring about the legislation. The deregulation of the financial services industry is by no means different. There were a number of forces influencing banking reform. It is the intent of this chapter to give a complete background on the forces that were operating that shaped bank deregulation. It is also the intent of this chapter to show that unlike regulation in the past, congress intent was to leave banks regulated as little as possible both in the immediate and long run future.

It is significant to note that much of the legislative reform in the 1980's mandating structural changes in the financial systems actually occurred quietly during the 1970's.² During this time period banks were receiving competition from savings and loans and other traditional financial service organizations and money market mutual funds. Savings and loans were able to offer services that banks could not provide. Mutual funds were experiencing interest rates at times over 3 percentage points higher than the 5.25% maximum that could be offered by banks. A key example of traditional financial service organizations giving banks increased competition, is the fact that in December 1981 General Motors was the largest consumer lender and Sears was the fourth largest lender. By 1984 it was projected that insurance companies, retailers and security dealers could offer virtually every financial service that banks and savings and loans could offer.³ In addition to the increased competition that banks and

savings and loans were feeling from their competitors, they were also feeling pressure from their customers. Many of the businesses that were doing loan business with banks began to issue commercial paper and other forms of direct placement designed to seek lower interest rates. As you can see while the banks competitors were reaping the benefits of a changing financial market the banks had their hands tied by regulations.

The deregulation of the banking industry was spurred by a number of factors. The first of these factors was the fact that thrifts, such as savings and loans, were experiencing a number of problems. During the period between 1979-1982 the thrifts were experiencing financial difficulty. These difficulties stemmed from the fact that thrifts receive fixed rates of returns on assets while experiencing a rising cost of funds. During this time thrifts were bound by legislation to offer fixed rate mortgages rather than variable rate. Another problem concerning interest rates was the problems that were being experienced due to regulation Q.

The regulation Q problem can be best explained by the fact that banks and other depository institutions were unable to offer competitive rates and hence lost funds to other competitors.⁴ Some of the competitors that the depository institutions were losing funds include, money market accounts and mutual funds. Federal reserve membership also posed a problem to depository institutions. Prior to deregulation membership in the Fed was not mandatory for state banks. This meant that state banks could remove themselves from the Fed membership and thus have an unfair

advantage over national banks. This advantage comes from the fact that holding reserves cost the banks money. The money that is being held as reserves cannot be loaned out. Of course because banking operates on a fractional reserve system the state banks do have to keep some reserves, but they are commonly far less than what Fed reserve members often keep. The equality or lack of equality is also another problem that regulations posed prior to deregulation.

During the time period prior of deregulation, regulations were becoming less and less defensible. As was mentioned earlier financial institutions found a number of ways to exploit loopholes in past legislation. The environment of the financial institutions was changing so rapidly that legislation that had lasted for years became obsolete. In addition to environmental change shaping deregulation, technological change also had a hand in the change in existing banking laws. Technological advances that were occurring made traditional boundaries between commercial banks and other depository institutions obsolete.⁵ Yet another factor that shaped or was a forerunner to deregulation was the growth rate in non-depository institutions. By this it is meant that in order to circumvent existing laws, many bank holding companies were breaking their services down into functional areas. This technique allowed the institutions that were formed to operate as non-bank banks and thus side step regulation. For example, a holding company could have a division that accepts deposits on one side of the street and a division that accepts consumer loans on the other side of the street. Another example of the increase in non-bank bank activities is Sears Roebuck and

Co. Sears as you know is one of the largest retailers in the United States. In addition to their retailing activities Sears also bought Coldwell Bankers one of the largest real estate operations and Dean Witter one of the nations largest investment bankers. As you can see Sears can offer consumer credit, sell real estate and investment banking services. The only level of competition that Sears cannot offer with banks is that of taking deposits. As you can see by these two examples the level of competition in the financial services was on a steady increase prior to deregulation. In connection with this factor is the fact that during the time frame prior to deregulation high and volatile interest rates were evident in the market. This had the effect of placing pressure on the financial condition of many banks and savings and loans which threatened to destroy the viability of the savings and loan industry as a whole. As much as one third of the savings and loans in 1979 were experiencing financial difficulty. The cost of funds for savings and loans were rising while the return on their assets was remaining constant. Profits were being squeezed out of the industry and the FSLIC, the corporation set up by the government to insure depositors was experiencing a drain on funds due to the increase of saving and loan failures. A final factor that can be sighted as a reason, at least in part, for the deregulation of the financial service industry is the fact that customers were becoming far more sophisticated than in the past. Customers were placing there funds into accounts that offered the highest rate of return. They also were shopping for the lowest possible

charges and for an increase in the services that could be offered. This was a key factor because the banks and other regulated financial institutions were unable to offer the services desired by their customers because of the regulations on product specialization. These previously sighted factors that were inherent in the deregulation primarily dealt with the problems banks and other financial institutions were having. Other factors, such as court rulings, also served to path a path for deregulation of the financial service industry.

Deregulation was viewed by most bankers as the only way to match unregulated competition, such as money market funds, which pay higher interest rates to savers. A development within the Federal Appeals court helped expedite what the bankers had been lobbying and circumventing for years. In a decision made by the Federal Appeals Court it was stated that existing laws on banking activities did not sanction such experiments as automatic transfer of funds between checking and savings accounts.⁷ It was felt that this decision would force congress into redesigning banking legislation. It was also apparent that it would be virtually impossible for congress to isolate the change in legislation just to automatic transfers. Congress had to address interest rate ceilings, electronic fund transfers and Federal Reserve Membership all at the same time. It was stated in Business Week in early January that reform had come due to the fact that the change in the financial system has out run the ability of regulation to control it. It was aparent through the decision that the courts were sending a message to Congress

demanding to know why the nations banking laws have failed to keep pace with the developments in the financial markets.

Just prior to and immediately following the court decision, a number of congressmen jumped on the band wagon initiating selected measures of bank reform. The then Chairman of the Senate Bank Committee, Jake Garn, felt that The National Banking Act of 1933 (Glass-Steagall Act) was due for a major rehaul. Garn said, "The lines separating competitors has blurred to the point where the restrictions of the Glass-Steagall act are more strained than ever." He proposed that commercial banks and thrifts be permitted to underwrite state and local revenue bonds. He also felt that banks, thrifts and credit unions should be allowed to setup all forms of mutual funds. Congressman Douglas Banard felt that in addition to the powers expressed by Garn, banks should also be able to underwrite corporate debt securities. The influx of legislation that occurred during this time period is far too numerous to be expressed within this paper. Each committee and each congressman had proposals for banking reform. It was my intent to give examples of the type of proposals that were introduced that were both relevant to deregulation and to this paper. The final factor that spurred deregulation can be seen on a cost benefit basis.

The approximate cost of complying with government regulations is between 50-150 billion dollars a year. This is now in the same league as industry outlays for new plant and equipment.¹⁰ In addition to becoming costly for industries as a whole to comply with governmental regulation it is also becoming prohibitively

expensive for the government to enforce the regulations. Therefore one of the hidden reasons for bank reform is due to the constraints imposed by the deficit in the budget. It is therefore the strategy of the Reagan administration to keep regulatory costs at a minimum. This can be seen by the following strategies being used for regulatory control by the Reagan administration:

1. Appoint regulators who clearly support Reagan's determination to reduce governmental intervention.
2. Use power of executive order and seek budget cuts to rein in agencies under presidential control.
3. Ask Congress to enact fundamental reforms that would apply to independent agencies not under executive control.

The Reagan administration also has a number of principles that will help guide the deregulatory push. The first of these principles is to impose regulation only when the benefit of doing so exceeds the cost. Tied to this principle is the fact that if regulation is deemed necessary the least expensive method of regulation is to be chosen. A third principle is to encourage the use of economic incentives for organizations to meet standards as opposed to rigid compliance rules. Another principle is to try to shift the regulatory burden (some might say control) to the states. The final principle that was an aid in deregulation in the past and will be an aid in the future, is the support of "Sunset" legislation. By this it is meant, legislation requiring Congress periodically to assess the current relevance of regulatory

laws. This will be a definite aid in keeping legislation up to date.

As you can see from the previous analysis, the deregulation of financial services had a number of important catalysts. These catalysts ranged from increased competition by non-bank bank operations, to government policy stressing the importance of non-intervention of government into industries. This chapter served the purpose of examining the environmental and market conditions that helped shape deregulation. Now that the environment prior to deregulation has been examined it is possible in Chapter three to explain the two pioneering legislations in bank reform: DEPOSITORY INSTITUTIONS DEREGULATION AND MONETARY CONTROL ACT OF 1980 and the GARN-ST. GERMAIN DEPOSITORY INSTITUTION ACT OF 1982.

CHAPTER THREE
THE FORERUNNERS OF BANKING
DEREGULATION: DIDMCA & GARN-ST. GERMAIN ACTS

The previous chapters within this paper dealt exclusively with regulations prior to the deregulatory move. It is the intent of this chapter to explain the DEPOSITORY INSTITUTIONS DEREGULATION and MONETARY CONTROL ACT of 1980 and the GARN-ST. GERMAIN DEPOSITORY INSTITUTION ACT of 1982. This chapter will give an in depth study of the acts including provisions and "expected" effects of the legislation.

Deregulation took place on three dimensions. As mentioned earlier these dimensions are price deregulation, product deregulation and geographic deregulation. It was the intent of price deregulation to lift legal restrictions on interest rates that banks and other depository institutions pay to obtain funds and the rates that they charge for loans. Prior to this type of deregulation banks were forced to offer no more than the legal maximum interest rates for deposits. For example, pass book savings accounts could offer no more than 5.25%. If you would recall, it was the fact that depository institutions could not offer these higher rates that lead loyal bank depositors away from banks and to money market and mutual fund accounts. The deregulation of product specialization came in the form of legislation addressed at a variety of services that could now be offered. These services include: investment services, insurance and underwriting. The final form of deregulation that that was apparent in the following legislations was that of interstate banking. While deregulation did not make it legal to pursue interstate branching, it made market markets in other states more accessible to banks and other depository institutions.

The DIDMCA of 1980 has nine titles or provisions. These titles are summarized in table 1a.

TABLE 1a

- TITLE I : The monetary control act
 - TITLE II: Depository institutions deregulation act
 - TITLE III: Consumer checking account equity act
 - TITLE IV : Powers of thrift institutions and miscellaneous provisions
 - TITLE V : State usury laws
 - TITLE VI : Truth-in-lending simplification and reform act
 - TITLE VII: Amendments to the National banking laws
 - TITLE VIII: Financial regulation simplification act
 - TITLE IX : Foreign control of U.S. financial institutions
- =====
- SOURCE: Commercial Bank Financial Management, Joseph F. Sinkay, pg. 161

TITLE I Monetary Control Act of 1980

The monetary control act of the DIDMCA was designed primarily to strengthen the Federal Reserve Board's ability to conduct monetary policy.¹¹ This provision established new reserve requirements and expanded the levy of those requirements to all depository institutions, including those that were presently members of the Federal Reserve System. The act also provided for identical reserve requirements for member and non-member commercial banks, thereby sharply reducing the incentive to withdraw from the Fed.¹² The services that the Fed previously only extended to members were expanded to all depository

institutions due to this provision. These services included the use of the discount window as well as check clearing and Fed wire services.

The reserve requirements are outlined in the following table which was originally illustrated in "Capital" and "The American Bankers Association", April 8, 1980 pg. 26.

Table 2a.

Reserve Requirements		
Type of deposit and deposit interval	Initial	Interval Range
Net transaction accounts		
\$0-25 million ^a	3%	-
Over 25 million	12%	8%-14%
Supplemented ^b	-	0%-4%
Nonpersonal Time Deposit		
Less than 4 years	3%	0%-9%
4 years or more	0	-
Eurocurrency Liability		
All types	3%	0%-9%

^a The \$25 million figure is indexed annually and would rise and fall at a rate of 80% of the inflation rate

^b The FRS will pay interest on any supplemented reserves

The effect that this title would have on depository institutions would come in the form of decreased profits. Reserve requirements have the same effects as taxes. The money that could be lent out for a given return would have to be kept as reserves. The money that is lost acts to decrease profits

much like taxes do. Title I also gave the FRS the power to impose supplemental reserve requirements on transactional accounts.¹³ Title I also established fees for its services. The services that have been subject to pricing include currency and coin deliveries, check clearing and collection, wire transfer etc.¹⁴

TITLE II Depository Institution Deregulation Act

The main provisions of Title II called for the phase out or elimination of Regulation Q. Regulation Q refers to the legal maximum that was imposed on interest rates payable on time and savings deposits. This phase out was to occur over a six-year period beginning on March 31, 1980 and ending on March 31, 1986.¹⁵

The phase out schedule for Regulation Q is outlined in table 2c.

Table 2c.

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The Scheduled Phase Out of Interest Rate Ceilings

Aug 1, 1981:	The end of ceilings on deposits maturing in 4 years or more
Aug 1, 1982:	The end of ceilings on 3-4 year deposit ceilings
Aug 1, 1983:	The end of ceilings on 2-3 year deposits
Aug 1, 1984:	The end of ceilings on 1-2 year deposits

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Source: Business Week, July 27, 1981 pg 29

The phase out schedule was only given as a model for interest rate deregulation. The actual legislation only stated that interest rates should be phased out as soon as feasibly possible and the Federal Reserve System had the powers to speed up or slow

down the phase out.¹⁶

The major effect this provision was expected to have on depository institutions was the increase in the cost of funds. With the cost of funds increasing it is only logical that profits would in-turn decrease. Of course the banks and other depository institutions will not absorb all of this increase in costs. As one can imagine most of the cost will be passed on down to the customers in the form of higher beginning balances, higher minimum balances, increased fees and increase in loan rates. Also it was thought that in the face of decreasing profits, managers would attempt to take on more leverage to maintain acceptable levels of return on assets and return on equity.¹⁷ It can also be assumed that this increase in leverage will come at the expense of the quality of loans. As depository institutions seek more and more loans the quality of the loans is bound to decrease. This in-turn would leave banks and other institutions in similar circumstances with riskier loan portfolios which could lead to higher loan losses in the future.

Title III Consumer Checking Account Equity Act of 1980

It was this provision within the DIDMCA that gave depository institutions the authority to provide a variety of checking account services. In other words it was Title III which gave depository institutions the power to offer Negotiable Order Withdrawals (NOW). Initially these accounts were only available to individuals and non-profit organizations. Prior to this Title it was illegal to offer an interest rate on checking accounts.

Title III did just that, offered interest rates on checking accounts. This provision had the effect of increasing the average cost of funds. The cost of funds for NOW accounts could be as high as three percent higher than the cost of funds of savings accounts.¹⁸ Title III also addressed the problems that the courts had with Automatic Transfer Services. As was mentioned earlier in Chapter 2, upon reviewing banking legislation, the courts found that there was no legislation that gave the banks the authority to offer ATS. Title III gave institutions the authority to offer such services as ATS. Another provision that was addressed by Title III was the deposit insurance on individual accounts. It is my belief that Congress wanted to send a message of safety with their first move into financial deregulation. Congress did this by increasing the deposit insurance on individual accounts from \$40,000 to \$100,000 which would be effective immediately following the passing of DIDMCA into law. The mechanism for determining the credit banks receive against their annual assessment for deposit insurance was also revised.¹⁹ In effect this title of the DIDMCA would allow thrifts and smaller banks to attract larger depositors through the increase in services that could now be offered.

Title IV Power of Thrift Institutions
on
Miscellaneous Provision

In order to understand this portion of DIDMCA it is first imperative to understand the traditional role of thrifts prior to deregulation. In general, thrifts were forced to specialize in

residential mortgages and credit unions were forced to specialize in the consumer loan market.²⁰ Title IV allowed thrifts to despecialize from the previously mandatory product specialization. Some key areas that became available to thrifts due to this title include 1) lines of credit, 2) mortgage loans of unlimited amounts, 3) no geographic restrictions on lending.

The major impact of this act was an increase in the growth rate of thrifts. Also a highly competitive environment for depository institutions which in general would mean thinner profit margins.²¹

Title V State Usury Laws

It was the intent of this title to eliminate state usury ceilings on a variety of federally insured lending institutions' loans. The key factor and main thrust of this title is the fact that it enabled financial institutions to lessen the drain on revenue due to the phase out of Regulation Q and due to the increase in the cost of funds brought on by offering NOW accounts.

Title VI Truth-in-Lending Simplification and Reform Act

The purpose of this title was to "streamline" truth-in-lending disclosure requirements. It requires all lenders to report all key aspects of a loan in a uniform method. These key aspects include the annual percentage rate (A.P.R.). The simplification will allow borrowers the chance to comparison shop for the best

lending rates more easily. Prior to this requirement lenders could state percentage rates on loans in a variety of ways which had the effect of easily confusing the borrowers.²² The act also made it easier for lenders to comply and limit civil liability for statutory violation.²³ This title also had a provision that was retroactive. If a lending institution was off by more than one percentage point from the APR they would be forced to pay a penalty to the borrower. You can see how the Reagan administration's policies of simplified legislation and economic incentives to comply with legislation had some effect in the deregulation of financial services.

Title VIII Financial Regulation Simplification Act

Title VIII is a direct result of the Reagan administration's attempt to simplify regulations. Title VIII requires the administration of a cost benefit analysis on all new regulatory actions. It also required that acts be written as clearly and as simply as possible. Title VIII also provided for the periodic review of regulation to check for current relevance and for its benefits as opposed to its costs. Title VIII made or has the intent of making regulation more understandable and less frequent.

GARN-ST. GERMAIN DEPOSITORY INSTITUTION ACT OF 1982

The main architects of the Garn-St. Germain Act of 1982 were

Senator Jake Garn (mentioned in Chapter 2) and Congressman Fernand J. St. Germain. The act has eight titles which can be broken down into those titles concerning the source of funds and those titles concerning the use of funds.

Title III, perhaps the best known portion of the legislation, allows for the authorization of money market accounts. The account would be federally insured and pay interest rates conceivably unrestricted. There will however be a limited number of transactions²⁴ In addition the act also authorized the creation of the SUPER NOW account. This is fundamentally equivalent to the NOW account except that would be now limit on the number of transactions. Title VII of the act permits federal, state and local governments to hold NOW accounts. If you remember previously Now accounts could only be offered to individuals and non-profit organizations. Title VII also allows federally chartered savings and loans and savings banks for the first time to make draft loans, invest in the accounts of other institutions and make commercial loans.²⁵ It also gave the power to invest in state and local government obligations, make residential and non-residential real estate loans, and make consumer and educational loans. In addition thrifts were given the power to alter their charters. Due to this act thrifts could now change from state to federal charters and from federal to state charters. The problem of fixed rate of return on thrift loans was also addressed in this legislation. The act gave state banks and thrifts the authority to offer variable-rate mortgage instruments. They could in other words offer mortgages like banks

The final provision that was addressed within the Garn-St. Germain Act was the lending ability that financial institutions could achieve with individuals. The act provided for institutions to loan up to 15% of their capital to individual borrowers. The previous limit on individual lending was 10%. This privilege was afforded only to loans that are secured by readily marketable collateral. The final provisions that the act set up dealt with emergency powers given to certain regulatory agencies.

Emergency powers are the subject of Title I and Title II of the Garn-St. Germain Act. These titles enhanced, for three years, the powers of the Federal Deposit Insurance Corporation and Federal Savings and Loan Insurance Corporation have over troubled banks. The agencies were given the power to aid institutions which are closed, insolvent, in default or endangered; or where severe financial conditions exist that threaten the stability of the financial institution or in order to reduce the corporations exposure to risk.²⁶ It also allowed these institutions to issue guarantees; purchase or assume an insured institution's assets or liabilities; make loans and contributions to and deposits in a troubled insured institution or company that will acquire it; organize charter conversions; arrange extraordinary mergers and acquisitions; and issue net worth certificates to banks and thrifts with substantial residential real estate loans.²⁷ State line boundaries could also be crossed for emergency acquisitions if either the FDIC or the FSLIC deemed necessary. These powers were given to the

agencies to avoid a potential crisis due to the fact merger partners were becoming harder and harder to find.²⁸ The industry took no time at all in taking advantage of their new powers. In 1982, the Federal Reserve Board and the FHLBB started to authorize both interstate and interindustry mergers, including Citicorp's²⁹ acquisition of Fidelity Federal Savings and Loan Association.

Although the DIDMCA and Garn-St. Germain acts were a large step in the process of financial reform, many issues were left vague. Interstate banking was addressed only as a means of rescue, investment banking activities were given to financial institutions, but not to the extent that was hoped for by the industry. I believe that Congress was merely testing the deregulatory waters by passing the two ground breaking deregulatory acts. Congress wanted to see the effects these initial changes would have on the industry and then react from there. As you will see in Chapter 5 Congress did continue its trech into deregulatory waters even after the success of the initial deregulation brought on many side effects that will be discussed in Chapter 4.

CHAPTER FOUR
EFFECTS OF INITIAL DEREGULATION

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Due to the fact that the DIDMCA and the Garn-St. Germain Acts were passed seven and five years ago respectively with the final phase of DIDMCA occurring last March, we can now see some of the long term effects of the initial phases of deregulation. Obviously there was some deviation in the outcome that Congress had anticipated and the actual outcome that occurred. Since the first wave of deregulation there has been additional financial deregulation and reform. Although deregulation did have many positive effects it also had many wide sweeping side effects. It is the focus of this chapter and subsequent chapters to discuss the effects of the initial deregulation and also discuss proposed deregulation and reform that has occurred since 1982.

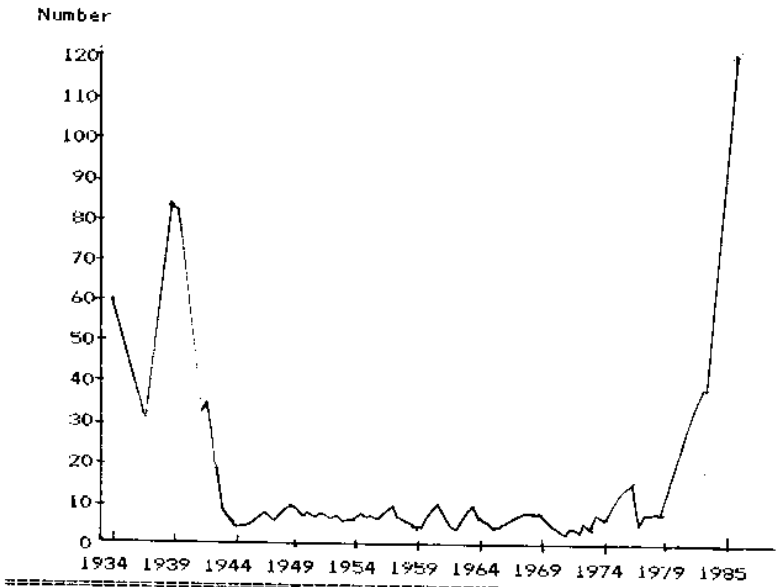
One of the major side effects that had occurred, at least in part, due to deregulation was the increase in failures of financial institutions such as banks and thrifts. In 1985 alone there were a record 120 bank failures.³⁰ In addition 1100 banks were labeled as problem banks. To understand the magnitude of this figure it is helpful to know that until 1981 there was an average of six bank failures a year. Therefore in 1985 alone there were the same number of bank failure that occurred between the 1960's and 1970's (on the average). I believe that Congress envisioned an increase of bank failures upon deregulation for two reasons: 1) With the increase in competition that deregulation brought about, there was bound to be a squeeze put on those banks that were operating less efficiently than others. 2) Some of the banks that were financially strong prior to deregulation, could not put up with the increases being attributed to the cost of

funds. Congress could not have overlooked these two facts. What I don't think Congress planned on was the poor economic conditions that existed in the market place which helped to compound problems.

In 1980 and 1982 commercial bank loan quality suffered, recall the reasons stated in Chapter 3 for this. The improvement of loan quality was hampered by a number of economic factors.³¹ Loan quality suffered due to the fact there were periods of high inflation followed by periods of low inflation, high real interest rates (which signifies a lack of confidence in the market), reduced demand for commodities caused by embargos, and declining farmland and energy prices.³² The significance of the economic forces on bank failures can be seen by the percentages of banks failures within certain sectors of the economy. Of the total 289 bank failures reported from the period of 1982 through 1985, 201, or about seventy percent, occurred within ten states which were linked to farming and energy industries. An interesting point that should be made is the fact that losses attributed to foreign bad debt did not have a significant impact on the bank failures. As was stated earlier the major reason for the deregulatory impact on the failures was due to the increased competition. Deregulation increased competition which forced banks into a harsher environment.³³ By this it is meant that because of deregulation there was less of a tolerance for poor management, fraud, insider abuse, etc. Risk taking was also stepped up due to the increase in cost of funds and the race for the new source of funds in the market. As you can see from the

above analysis deregulation was not the sole reason for bank failures, but it did have a significant impact on the increase in failures. The following is a graphical representation of the increase in banking failures.

Table 4a
FDIC-Insured Bank Failures



SOURCE: FRBSF WEEKLY LETTER, April 11, 1986, pg 3.

Commercial banks were not the only financial institutions that were experiencing problems. Thrifts, such as savings and loans were also experiencing a great deal of problems. If you recall a number of the provisions in the Garn-St. Germain Act were initiated to help thrifts. Also the emergency provisions were enacted to aid failing or failed institutions. In 1986, four

years after the Garn-St. Germain act was passed, the failures of savings and loans were so prevalent that the FSLIC was left \$5 million short.³⁴ By Federal regulatory rules many thrifts were considered to shaky to stay in operation and should be merged or closed.³⁵ Approximately one-third of the thrifts were in bad shape. The biggest problems that thrifts were experiencing were due to bad investments made 5-6 years previously when there was an expansion of powers given to the thrifts.³⁶ A bill was introduced in 1986 that would aid these failed institutions. The bill called for failed institutions to be purchased by healthy buyers across state lines. If you recall, the FBIC and the FSLIC were given the power to do this in 1982 but the measure was only temporary. This bill would allow for the power to cross state lines in mergers and acquisitions on a permanent basis. The bill would also allow the institutions to be kept open for operations until a suitable buyer could be found. This would limit the inconvenience to the customer. Also, by allowing institutions from out of state to participate in the bidding process, the FSLIC would be able to counter the fact that suitable bidders were becoming scarce.³⁷ The bills main opposers, Senator William Proxmire and Senator Fernand St. Germain, refused to back the bill unless it had provisions that would eliminate non-bank banking activities. Their rational was that there would be no incentive for an institution to buy a failing institution across state lines when an institution could move across state lines by using non-bank bank activities. The remedies that this bill sought would blurr distinctions between thrifts and banks and

also speed up the possibilities of interstate banking.³⁸
Another remedy that was discussed was to increase the insurance premiums of the FSLIC. But, what should be immediately apparent is the fact that in the face of higher premiums many thrifts would take advantage of their power to change their charter, which was given to them by the Garn-St. Germain Act. This would leave the the FSLIC with even a greater percentage of troubled institutions. Therefore this was not a feasible solution. The final solution will eventually be left to Congress, but as you will see in the following chapter a bill was again introduced, which had the provisions St. Germain and Proximire were demanding.

The financial institutions were not the only entities that were experiencing difficulties due to deregulation. Consumers were also experiencing problems that were the direct cause of deregulation of the financial service industry.

The problem that the consumers were having reached such magnitude that a policy statement had to be issued by the FED. The policy statement encouraged commercial banks to ease restrictions that have made banking prohibitively expensive for moderate and low-income individuals.³⁹ The statement said that the change in the financial markets due to deregulation had only succeeded in hurting low income individuals. The changes that were occurring included increases in banking service charge, minimum balance requirements and also higher opening balances were being required.⁴⁰ The statement urged that individual banks insure that low income individuals have access to a safe place to keep money, a way to get cash, and a means to make third party transactions.⁴¹ The Association of Community Organizations for

Reform (ACURN) said that low and moderate income families and individuals are being priced out of banking services and called for public officials to act immediately to reverse the trend. The FED chose to issue the statement as a warning to the banking industry that unless they start a policy on self regulation (a principle now familiar in the Reagan administration) , legislation would be enacted to force compliance. While the rates for minimum balance have not fallen, they have stablized, so we can make the assumption that the banks got the message- at least for the time being.

One of the problems related to the increase in bank failures is the fact that in 1986 there were a shortage of bank examiners. This shortage has several roots. These roots include budget constraints; higher salaries offered elsewhere in the industry; and the fact that staffs were reduced in the 1980's due to the fact that there weren't a significant number of bank failures in the early 1980's. In addition to the shortage of examiners, the examiners that were present lacked experience. The examiners on staff had an average experience of 2.67 years, while in order to be totally effective at examining it takes a good five years experience.⁴² The effect that lack of experience had on the examination process was that the process became longer. The length of time was also being increased due to the increase in problem banks. It is far easier to examine a healthy institution than it is to examine a problem one.⁴³ The effect these three factors(shortage of examiners, inexperienced examiners, and longer examinations) was that some institutions

were not being examined for over a year. You can see the effect of lack of examination had on some of the problem banks. With no examination to notify managers of problem areas, the problem was left unnoticed until it festered into a failing institution. The final major effect that deregulation had was on the amount of mergers experienced in the financial market.

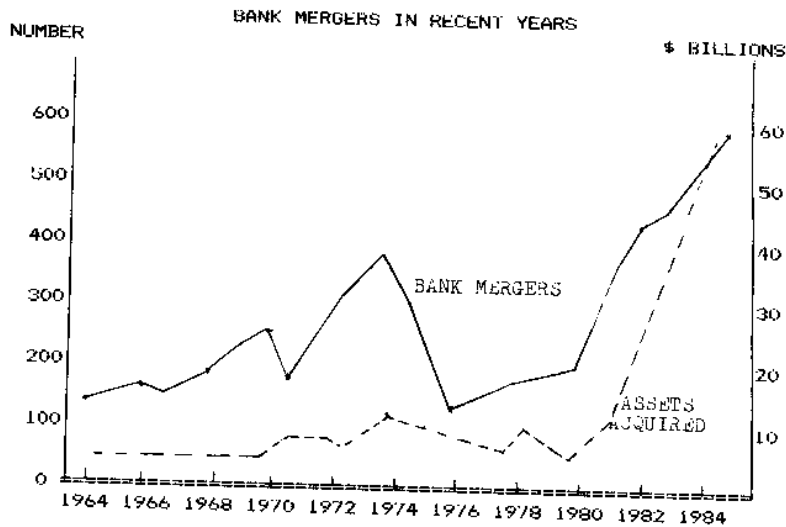
The increase in mergers has been due both to legislative changes and judicial rulings. Since the enactment of DIDMCA and the Garn-St. Germain Act, banking agencies and the Department of Justice have recognized thrift institutions as competitors to commercial banks. This inclusion of thrifts into the competitive framework, tends to lead to a new view of the market structure as being more atomistic and less concentrated.⁴⁴ Four criteria were set which had to be met before a market merger would be rejected. These criteria are as follows:

1. The target market that is being operated in is non-competitive.
2. The acquiring firm is a likely entrant in the target market.
3. There are few likely entrants in the target market.
4. The merger would encourage competition in the market structure.

A startling fact in the topic of mergers is that no banking agency has denied a market extension since 1980. The competitive framework was again changed to include financial competitors and brokerage firms. Therefore the likelihood of the trend of increasing mergers is not likely to reverse itself.⁴⁵ It was stated in the December 1986 issue of FRBSF WEEKLY LETTER that the

Department of Justice revised its horizontal merger guidelines in ways that most observers agree would continue to allow more mergers. The following is a graphical representation of the merger activity.

GRAPH 5a



SOURCE: FRBSF WEEKLY LETTER, Dec. 26, 1986, pg 3.

As you can tell from the anyalsis in this chapter, deregualtion had many side effects that were not anticipated. Although Congress did not anticipate them, I don't think they came as a surprise to Congress. In order to experiment in the deregulatory waters it was necessary for Congress to assume some risk, unfortunately these risks involved a variety of factors that were discussed within this chapter. Congress has attempted

to remedy these solutions in order to achieve the outcome that they had desired; namely a smoothly running and efficient financial market system that acts to regulate its own activities and provide a better system to the consumers. Of course this will take time. Additional legislation that has been introduced since the initial deregulation will be discussed in the following chapter.

CHAPTER FIVE
DEREGULATION AND REFORM SINCE 1982: AND PROSPECTS
FOR THE FUTURE

While Chapter 5 dealt primarily with the problems that were experienced due to the initial deregulatory acts, the main thrust of this chapter will be legislation that has been introduced, passed or failed that have taken place since 1982. This chapter will also have a brief summary on the bills before Congress as of April 23, 1987.

One of the first measures that was enacted by Congress, was a measure that would be used to prop up the value of savings and loans. This would have the effect of deferring closings while a long term answer to the thrift problem is sought.⁴⁶ One provision of this measure would be the increase in net worth requirements. In the early 1980's the requirements for net worth were lowered to three percent of assets. The previous level of net worth requirements was six percent. The initial lowering was performed so many thrifts could meet operating rules.⁴⁷ Congress also adopted a net worth policy that ties reserves to the institutions activities.⁴⁸ The measure also called for a one-time levy on deposits of one percent. It also called for the continuance of seeking bidders for ailing institutions. The FSLIC also wanted the legislation to open bids to a variety of industries, which it did in 1985. It was the hope of this legislation to bring thrifts out of financial difficulty. The bill would make thrifts sounder because of the increase in capital required and it would also allow for failing institutions to be acquired more rapidly by healthy organizations. The measures taken by this bill would also increase the FSLIC funds

and pose the continuing question of interstate banking.⁴⁹ In a related issue there is a proposal in front of Congress in April, 1987 that would call for the recapitalization of the FSLIC. The bill is entitled HR 27 and its major provision would be to shore up the FSLIC insurance fund. According to a staff assistant in the House Banking Committee that the bill that is before Congress for debate is significantly different from the bill that was introduced. She stated that because of this the original bill would be useless for examination of provisions. The final report is being written and will be reported to Congress in early June.

Further legislation was also proposed for savings and loans in 1986. The most significant of these is the proposal that would allow interstate branching of Savings and loans. This proposal would allow the FHLBB to increase the value of its thrifts and to cut the amount the FSLIC would have to pay healthy financial institutions to induce them to buy ailing thrifts.⁵⁰ The proposal would also allow the FHLBB to issue 8-10 billion dollars in bonds to provide new funding to the already strained insurance fund. These bonds would also be backed by the earnings of the FSLIC.

Current legislation is also being discussed that would change capital requirements for commercial banks. The bill, which was introduced last year and reintroduced earlier this year, called for the increase in capital requirements. Capital is composed of the stockholders investment and the profits that the bank has kept in reserves over the years. Capital acts as a cushion against loan losses. The bill also sought for capital

requirements to be tied to the type of activities the banks were involved in. Banks involved in riskier activities would be required to hold more capital than those banks which were involved in less risky activities.

Risks of different types of assets would be rated from vault cash at the low end to foreign loans at the high end.⁵¹ Total capital requirements would be the weighted average of each category of assets. The bill would allow for banks with different asset to maintain similar levels of profitability. This can be considered beneficial because it lessens the perceived need to increase risk in order to increase profits. This should have the effect of increasing loan quality overall. Legislation was also proposed that would expand the powers of banks and bank holding companies.

In January 1986 the courts provided banks with the power to pursue activities in the discount securities brokerage securities. Specifically it allowed banks to offer discount securities brokerage services to their customers. Banks were given the opportunity to offer these services as a chance to diversify their range of financial products by offering services such as brokerage securities.⁵² This piece of legislation was met with some resistance from security dealer organizations. The Security Industry Association felt that by offering the brokerage service to new customers, the banks were overstepping the scope of the legislation. The association felt that the courts had intended banks to only offer the security service to its old customers, not to solicit the fact that they could offer such as

service to the general public. The association was angered because they were now receiving competition from banks, where previously they were free from such competition due to strict enforcement of the Glass-Steagall Act.

As was mentioned earlier, bank holding companies were also given additional powers in the years following initial deregulation. Bank holding companies were given the power to offer financial and tax counseling, debt collection and credit checks.⁵³ These functions allowed them to get a further foothold in financial services ranging from underwriting corporate securities to full time issuance of commonstock.⁵⁴ It was necessary to expand the services that bank holding companies could offer due to the squeeze in profits that they were experiencing. In addition to the power to offer those services, Congress (under a different proposal) gave bank holding companies the the power to make limited investment in real estate. The proposal also called for a corresponding decrease in the investment in real estate that state chartered banks could offer. Due to the fact the states had just passed legislation that would increase the powers state chartered banks could make in real estate, this proposal would undoubtedly end up in a variety of law suits.

Messages were also being sent by the courts that could signify additional change in the future. A message was sent that full service investment banking is not to far off in the future was given when regulators allowed Sumitomo, a Japanese bank, to acquire Goldman Sach & Co. an investment company. If regulators are going to let foreign banks participate in investment banking,

investment banking for domestic banks is not to far off.

Automatic teller machines also were addressed in legislation following 1982. ATM's were given the power to branch across state lines in order to accept deposits. The major effect this legislation would have is that it could crowd out smaller banks that cannot afford to flood the area with machines. Although the legislation does allow for the acceptance of deposits across state lines, ATM's are still considered branches by the regulators and thus are subject to federal laws prohibiting interstate branching.

With all the deregulation that was proposed since 1982, the regulatory agencies have also been the subject of proposed change. A report presented by the Fed called for a massive restructuring in order to eliminate significant overlap and duplication in the responsibilities of the agencies.⁵⁵ The fragmentation has impaired the effectiveness of the regulatory system in maintaining safety and soundness.⁵⁶ It is obvious that due to deregulation the regulatory system would have to adapt. The proposal given in the report called for functional regulatory control. Each regulator would be solely responsible for supervising specific banking and non-banking functions. It called for the S. E. C. to regulate all types of security transactions. It also provided for the merger of the FDIC and FSLIC, due to the fact that the two industries are becoming increasingly similar, and the creation of a banking superagency that would unify the regulation of the banks and their holding companies.⁵⁷ What ever the final decision, it is imperative that

there is some change in the regulatory system that could deal with the problems more accurately and effectively.

As I stated earlier, legislation that is currently being proposed by Congress would be discussed. After talking to several members of the House Banking Committee and our Congressman and Senators staffs it was found that there are currently three pieces of legislation before committees. The first of these is in front of a Congressional committee and calls for allowing banks into expanded powers. The second legislation is in the senate and calls for a one year moratorium on expanded powers. The third piece of legislation was HR 50, Congressman Barnard's bill. This legislation was unavailable for print at the time of this writing.

As you can see through the legislative activity on bank reform and bank deregulation, the legislator has been very busy. The legislator does not want to fall into the same pit fall of out dated regulations again. The market place has become highly sophisticated in recent years and it is my belief that the efforts of deregulation will continue to the next decade. Deregulation is in its infant stages right now and if allowed to nurture could have the desired effects that Congress is looking for that were mentioned earlier.

CONCLUSION

Originally this study was strictly going to be a study on the effects of financial deregulation on the market place. Upon researching the subject however, I found that a complete study of the deregulatory would be necessary in order to give one a thorough understanding of deregulation. It was the intent of this study to give you, the reader, a thorough knowledge of the deregulation of the financial service industry. I trust I succeeded on this count. Within this conclusion, rather than give an overview of what was discussed in the paper, I decided it would be more beneficial to discuss the lines of battle for future deregulation, reform and regulation that have been drawn earlier by chief regulators (Namely Paul Volcher, Chairman of the Federal Reserve System). The following discussion will attempt to give a complete explanation of the statement that Volcher made on June 11, 1986 to the Subcommittee on Commerce, Consumer, and Monetary Affairs of the Committee on Government Operations regarding future areas of bank reform.

Volcher stated that there is a need for an urgency to reform the existing statutes governing banking organizations.⁵⁸ He felt that the public was lacking in the assurance that there were forces operating that could control the changing financial system. The public feels that the change in financial institutions was occurring haphazardly and unchecked. One of the reasons that Volcher gives for this is the fact that legislation introduced in Congress was being bogged down by effort to block

the legislation. These efforts are being applied by those who perceive a strong particular interest in one part or another of the status quo or in exploiting existing loop holes.⁵⁹ Volcher called for comprehensive banking legislation, including provisions to close unintended and unwise loopholes in banking and thrift holding company statutes and to provide certain new products and services.⁶⁰ Volcher then went on to discuss the implications that regulations would have on certain topics such as banking structure, depository institution holding company acts and the linking of banking and commerce. Volcher's concern is a realistic one and for the most part drew lines on future legislation. As was stated earlier, Volcher did not give specific acts but merely gave general regulation and thus it is impossible for me to give any further information on detailed legislation that will be discussed in the future. In general though, legislation will be discussed for interstate banking and expanded powers in investment banking. Only time will tell. But remember, a change in administration or house control could have more of an effect in legislation than seven years of debate.