SHADOW FINANCIAL REGULATORY COMMITTEE

Administrative Office
c/o Professor George Kaufman
Loyola University of Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
TEL (312) 915-7075
FAX (312) 915-6118

COMMITTEE MEMBERS

LAWRENCE CONNELL
Co-Chair
Attorney-at-Law

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Co-Chair
Loyola University of Chicago

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Stanford Law School

SUPPORTERS INCLUDE

FRANK HAWKINS
KENAN INSTITUTE

LOYOLA UNIVERSITY OF CHICAGO

SARAH SCAIFE FOUNDATION

Statement No. 116

For information contact:

Robert A. Eisenbeis
(919) 962-3203

Edward J. Kane
(617) 552-2097

Statement of the Shadow Financial Regulatory Committee

Open Letter on Financial Reform to the Senate and House Banking Committees

February 13, 1995

Historically, Congress has tended to approach issues of financial structure in a piecemeal fashion, usually in response to a crisis in a particular sector of the financial system or to financial innovations. As a result, a complex, confusing and, at times, contradictory code of law and regulations has evolved. Administration of this system is fragmented. Consequently, the current regulatory system is costly and occasionally has been disruptive, with sometimes unintended consequences for financial institutions and the taxpayer. The efficacy of the existing structure and the effects that an evolving market place has had on institutions need to be evaluated anew.

Legislative initiatives have been introduced by the new Congress to modernize the financial system and will be debated in the coming months. The most important and pressing of these initiatives concerns the range of permissible powers for insured depository institutions and issues of their affiliations with nonfinancial institutions. The Committee believes that most restrictions on permissible activities (such as insurance and securities) and restrictions on affiliations among banks and nonbanking firms should be removed. To prevent this from imposing additional risks on the taxpayer and bank insurance funds, prudential protections in FDICIA 1991 should be strengthened, and Congress should expand its ability to monitor the performance of the federal banking agencies to ensure enforcement of the relevant sections of FDICIA 1991.

A. Restrictions on Affiliations and Permissible Banking Organization Activities

The 1933 Glass-Steagall Act restricts the extent to which banking firms can engage in securities activities and limits securities firms' ability to take deposits and affiliate with banking organizations. Removing the restrictions would improve the efficiency of markets and reduce costs to customers.[1]

The Bank Holding Company Act of 1956, and its amendments of 1970, limit combinations of banks with financial and nonfinancial companies. Part of the rationale for these Acts was fear of concentration of economic power and concern for undue risk exposure of insured depository institutions.[2] These concerns have been eliminated by increased competition and the threat of new entry by foreign and domestic banking and nonbanking organizations. Moreover, any residual risks can be potentially controlled within the existing supervisory structure.

Provisions of both the National Banking Act and Bank Holding Company Act unduly restrict permissible insurance sales. Synergies and risk reducing potential have been demonstrated to exist, and there is no evidence that coercive tying in the sale of insurance is an important problem. Therefore, the restrictions on insurance activities should be removed.

B. Strengthening FDICIA 1991 and Improving Congressional Monitoring of Agency Performance

Fears of undue risk taking by insured depository institutions can now be addressed within the structure of the prompt corrective action and least cost resolution provisions of FDICIA. FDICIA institutes procedures that can effectively insulate the taxpayer and insurance funds from undue risk. Under FDICIA, as an institution's net worth declines, the regulatory agencies are asked to follow specific supervisory procedures and to close capital deficient institutions before capital goes to zero. If the agencies act as directed, safety and soundness concerns no longer justify maintaining restrictions on bank activities.

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1 See Statement No. 56 (November 17, 1986).

Additional initiatives can enhance the effectiveness of FDICIA 1991. First, reliance upon market value, instead of the book value of net worth, should be expanded and linked to FDICIA's prompt corrective action and early intervention requirements.

Second, to ensure the long-term efficiency of federal banking regulation and to prevent unwarranted expansion of the federal safety net, the Committee believes that Congress must set up an explicit and multidimensional system for monitoring regulatory agency performance. Regulators are inadequately accountable for meeting FDICIA's requirements for prompt corrective action, least-cost insolvency resolution, risk sensitive deposit insurance pricing, and expanded use of market value accounting. The need for vigilant oversight is highlighted by a recent report by the FDIC Inspector General which indicates that the prompt correction action provisions of FDICIA were not always initiated by the FDIC in a timely fashion.[3]

Effective Congressional and public oversight of agency performance requires unambiguous statements of agency goals and transparency of decisions and underlying decision criteria. Regulatory agency performance will be enhanced by ensuring that all decisions and the reasons for them are made publicly available promptly.

C. Equal Credit Opportunity Act and Community Reinvestment Act

The Committee clearly distinguishes between two different Acts with different approaches to enforcement of civil rights laws affecting financial services. The Equal Credit Opportunity Act is designed to ensure each individual equal access to financial services on a non-discriminatory basis. The Committee strongly supports the goal of this Act. However, the Committee also concludes that the second approach, as embodied in the Community Reinvestment Act, is based upon the faulty economic premise that funds raised by depository

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2 See Statement No. 115 (December 12, 1994).

3 See Audit of FDIC's Implementation of the Prompt Corrective Action Provisions of FDICIA, Report of the FDIC Inspector General, Sept. 23, 1994.

institutions should be employed first in the communities from which they were raised, rather than where they can be most productively invested. This Act has degenerated into a costly credit allocation scheme. No evidence suggests that CRA has appreciably improved credit flows to low and moderate income areas. For these reasons, CRA should be repealed. Better and less costly ways are available to channel funds to socially desirable purposes. The best alternative is to transfer resources directly to address the long term problems of inner cities. Such programs should be expressly funded in federal, state, and local budgets, so that taxpayers can monitor their costs and assess their effectiveness.[4]

D. Burdensome Regulations

Other proposals on the legislative agenda address regulations which impose inefficiencies and large and unnecessary costs on institutions and customers relative to their benefits. These include: the Truth-in-Lending Act, Truth-in-Savings Act, Real Estate Settlement Procedures Act and the Home Mortgage Disclosure Act. These laws have resulted in either costly litigation and/or large compliance costs. Although lower in priority, these Acts are worthy of reevaluation and examination of their benefits relative to their costs.

Mr. Hawke did not participate in the discussion, formulation or preparation of this statement.

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4 See Statements No. 105 (February 14, 1994) and No. 113 (December 12, 1994).