Restructuring Banks May Soften Deregulation's Impact

What Should Banks Do? By Robert E Litan Washington, DC Brookings Institution, 1987, 207 pages, $9 95

Reviewed by Stephen W. Hiemstra

A recent U S Supreme Court ruling upheld the right of several large commercial banks to underwrite commercial paper, municipal revenue bonds, and mortgage-backed securities, provided the activity involves less than 5 percent of their assets This ruling prompted the House Banking Committee in 1988 to reverse its opposition to bank reform legislation, which the Senate has proposed periodically over the past several years The legislation proposed in 1988 would have amended or repealed the Glass-Steagall Act of 1933, which separated commercial banking from investment banking by prohibiting commercial banks from underwriting most classes of securities The bank product deregulation discussion has, therefore, graduated from the philosophical to the legislative level

Litan, a senior fellow of the Brookings Institution, is one of a number of authors who has attempted to frame the bank deregulation discussion The book describes and analyzes deregulation issues to evaluate the efficiency benefits of permitting commercial banks to enter investment banking Permitting commercial banks to underwrite common stock, mortgage-backed securities, corporate bonds, and other securities currently forbidden will presumably allow banks to lower portfolio risk and to distribute overhead costs over more output

Litan sees deregulation as a response to two economic trends.-high inflation and technological change, particularly changes in information management Inflation led Congress to deregulate interest rate controls on banks and thrifts and led many financial services firms to adopt new products and other innovations for less costly managing, storing, and analyzing of financial data These changes strengthened the ability of nonbanking firms to enter traditional banking activities, while banking firms have been legislatively restricted from entering nonbanking financial services, such as securities and insurance underwriting This disparity in new opportunities, according to Litan, provides an incentive for banks to seek product deregulation legislation

In his review of the history of the U S financial system, Litan develops several themes One is that the role of banking regulation, going back to the 1930's, has been to ensure the safety and soundness of the banking and monetary system, promote fair and honest credit allocation, and limit the political and economic power of banking enterprises A second theme emanates from the "Real Bills" interpretation of the business of banking first expounded by Adam Smith Banking is the taking of deposits and the making of loans Advocates of the Real Bills doctrine emphasize the making of loans to cover the operating expenses of business (their real bills), arguing that by sticking to short-term loans banks will be able to maintain their liquidity during financial crises Demand deposits are extremely short-term liabilities and even short-term loans can leave a bank illiquid in the event of a bank run Following this theme, Litan suggests that reforms encourage banks to offer more mutual fund-type instruments and to offset deposit accounts with extremely safe, liquid assets, such as government securities

Litan sees three potential benefits of bank product deregulation It may enhance competition in financial service and reduce excess profit margins, particularly in investment banking It could lead to economies of scope, that is, cost savings due to the production of services with common and underused inputs It may allow banks to diversify their portfolios, reducing the combined risk of the assets they hold

Litan notes some risks of deregulation as well Instead of taking advantage of new opportunities to diversify, banks could use their new powers to take on greater risk, thereby compromising the soundness of the banking system He sees the potential for large banks and other financial institutions to accumulate too much economic and political power Banks might also abuse their greater freedom to offer new products to engage in noncompetitive practices

The challenge to lawmakers, from Litan's point of view, is to channel the energies released in deregulation toward achieving the benefits of deregulation while avoiding the risks He sees two approaches to accomplishing this objective One is to maintain the current institutional structure outlined in the Bank Holding Company Act of 1956 and to enact piecemeal regulation to deal with problems as they arise The second approach is to restructure banks so as to separate their deposit-taking and loan-making activities,

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creating finance holding companies to replace the bank holding companies The deposit companies would essentially become money market funds which could invest only in low-risk assets, such as government securities Their lending counterparts would acquire loanable funds through the commercial paper and other security market transactions By separating deposits from lending, regulation would be simpler Problems arising because the maturities of assets and liabilities were poorly matched (disintermediation) would be reduced Federally insured deposits would no longer provide a competitive advantage to one financial institution over another Litan views this second approach as the preferred route to take in legislating bank product deregulation

It is difficult to capture the richness of Litan's writing in a brief review His book reads quite well and yet provides a high level of technical detail throughout I found the references he cited interesting and have requested many of them for my own use and study

Although the general public has a lot at stake in questions involving bank regulation and reform, many of the topics raised in this discussion may be too technical for the average reader Graduate students in economics and economists should have no problem following Litan's arguments The book's availability in paperback should attract a wider readership than many other texts on bank deregulation