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Statement of the Shadow Financial Regulatory Committee

on

BANK ACTIVITIES AND THE EXTENSION OF BANK SUBSIDIES

May 5, 1997

An important issue in considering the desirability of expanding the range of bank activities and of permissible combinations between banks and firms in other lines of business is the existence of subsidies for the banking system and their possible extension into new sectors of the economy. The argument is made that this would be unfair to existing firms in these sectors and would enlarge the subsidy and taxpayer risk. This issue has pervaded recent Congressional deliberations on proposed banking legislation, and contributed to the failure of reform efforts.

The Shadow Financial Regulatory Committee believes the issue deserves careful analysis to put it into proper perspective. Several questions are presented: Is there in fact a subsidy? Is it significant? Need there be such a subsidy? What would be its implications?

The contention is that banks receive from the federal government a set of services that are priced at levels below cost. Banks may raise funds from depositors at lower rates with the benefit of a guarantee by the Federal Deposit Insurance Corporation. At present, since FDIC's Bank Insurance Fund has reached a statutorily-set ratio to deposits (1.25%), there is essentially no longer an annual premium assessment. Banks make large transfers of funds each day through the Fedwire payments system run by the Federal Reserve Banks, and are permitted to incur large overdrafts in their accounts, guaranteed as to final payment. These are intraday loans, amounting daily to tens of billions of dollars, for which the Federal Reserve Banks charge an annual rate of 15 basis points--far below the federal funds rate banks charge each other for overnight loans. In situations of financial difficulty, banks also have limited access to longer loans from the Federal

Reserve Banks (the "discount window") at below market rates. And in the background is the possibility that the Fed, if it believes general economic conditions warrant, may undertake to make available still more generous credit support.

There is no doubt that these "safety net" services are of substantial value to the banking industry. At the same time, their cost is not only the set of explicit charges; they are accompanied by an extensive and expensive blanket of regulation. Banks are subject to capital requirements and reserve requirements, to activity limits and geographical limits, to investment constraints and organizational constraints, to borrower protection laws and depositor protection laws, to examination costs and supervisory intrusions. When the safety net benefits are combined with the explicit charges and the regulatory burdens, is the result a net subsidy? On this question, opinions differ and convincing studies are lacking. Federal Reserve Board of Governors Chairman Alan Greenspan has testified that there is a subsidy and Comptroller of the Currency Eugene Ludwig has testified that there is not. Each, it might be noted, is advancing the regulatory cause of his own agency.

The conflict and uncertainty at least suggest that the net subsidy/cost is probably not particularly large. If that is the case, then the issue should not play a large role in the Congressional and agency debates over permissible banking activities and combinations with firms in other lines of business. However, if one were to assume that net balance now produces a subsidy of substantial magnitude, and that it is not competed away as banks strive for deposits, what should the implications be?

The most direct and effective response would be to devote effort to measuring and removing the subsidy, as the Committee has previously recommended (Statement No. 135, December 9, 1996). One approach is to correct the mispricing. In the case of the discount window and daylight overdrafts, the initial steps are obvious: the credit extensions should be at market or penalty rates. Market pricing of deposit insurance is more difficult, but could be assisted by devices such as using a limited amount of private co-insurance or requiring large banks to put a layer of (uninsured) subordinated debentures in their capital structure. The FDIC Improvement Act of 1991 has already approached the problem from the other end, providing for risk-based capital requirements, prompter corrective action

and earlier closure, in an attempt to lower the risk exposures and any subsidies to minimal levels.

If such steps are not taken, or are not fully effective, and a substantial subsidy were to remain, what is the consequence? It is important to distinguish between two sets of concerns: those of competing firms, and those of taxpayers.

A concern often voiced is that a substantial subsidy for banks would mean unfair competition for all firms into whose lines of business banks were permitted to enter. That confuses the issue of redistributional unfairness (why should banks be singled out to get a gift from the government and the taxpayers) with competitive unfairness (the unlevel playing field). If banks are given a wealth transfer, that may be objectionable social policy, but they are on the same playing field and will use the same criteria as everyone else when it comes to deciding how to invest it. A bank entering a new business faces the same activity risk, and to protect its market value needs to earn the same rate of risk-adjusted return, as existing firms; otherwise, it is just throwing away part of the wealth it was given.

Taxpayers, on the other hand, have reason to be concerned with the aggregate subsidy being provided to the banking industry, and with their aggregate risk exposure. If that is significantly increased, or is significant in the first place, they have legitimate grounds for objection. But, as already mentioned, that should be addressed directly. The safety net needs searching scrutiny as to its necessity; reciting the mantra of "systemic risk" is not sufficient. And to the extent the safety net needs to be maintained, the mispricing that currently characterizes it should be reduced or eliminated insofar as possible.

It is the Committee's policy that members abstain from voting on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard C. Aspinwall and Robert Litan abstained from voting on this statement.