

Does Bank Regulation Help Bank Customers?

Based on a speech given by President Santomero to the Frontiers in Services Conference, Bethesda, MD, October 26, 2001

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The answer to the question posed in the title is yes, no, and maybe, according to President Santomero. Yes: the government must absorb some of the risks inherent in the banking system in order to maintain the system's stability. No: regulations that ignore the self-interested reactions of both bankers and their customers will not serve those customers well. And maybe: bank regulations, in principle, can help if they increase competition or the flow of information. In practice, however, some regulations designed to improve the quality of information have met with mixed success. President Santomero suggests that focusing on improving both financial literacy and information disclosure might be more productive.

Since becoming a central banker, I have been considering the question: "Does bank regulation help bank customers?" As a long-time economist, my answer is: "Sometimes yes. Sometimes no. It all depends."

BANKS CANNOT SERVE THEIR CUSTOMERS WITHOUT SOME REGULATION

One way in which bank regulation and the associated process of supervisory oversight help customers is by keeping the banking system stable. At the most basic level, stability means that banks can provide a safe place to make deposits, and one that gives ready and reliable access to them when needed.

Bank regulations focused on ensuring that banks prudently manage

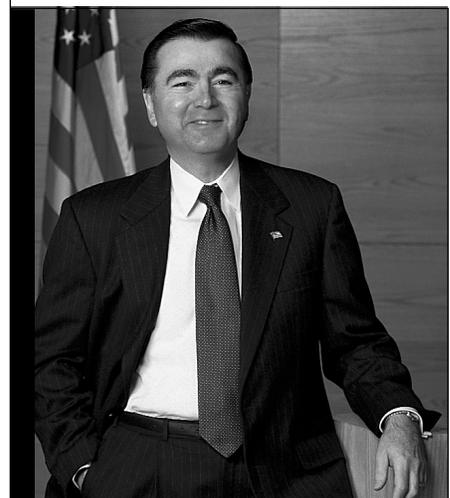
the risks in their portfolios and that they maintain adequate capital against unforeseen contingencies are part of a government infrastructure designed to bring stability to the overall financial system. For the U.S. banking sector, this infrastructure has evolved over the last century. It includes prudential regulation along with FDIC deposit insurance, the Fed's discount window, and the Fed's bank-to-bank payment system, called Fedwire. Each piece is necessary to ensure a stable banking system.

The core business of a bank is to take in deposits and make loans. Theoretically, depositors could look at the bank's balance sheet, assess the riskiness of the loans and securities outstanding, and determine the overall riskiness of the institution. If the risk level were too high for a depositor's

taste, he could take his deposit elsewhere.

The reality, of course, is considerably different. Depositors cannot assess the risks in the bank's loan portfolio very easily, since banks devote time and resources to developing an intimate understanding of the risk characteristics of a particular lending opportunity. The assets banks put on their books reflect their case-by-case judgments. Since depositors cannot see their bank's risk profile clearly, they cannot accurately assess the risk to which their deposits are exposed. This uncertainty creates the potential for instability in the banking system.

A banking panic is the classic manifestation of this instability. Some event, real or imagined, convinces depositors that their bank cannot meet its obligations to all of them, and so they rush to the bank to get their money back before the bank fails. Of course, depositors at other banks are also



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makes discount window loans available to otherwise healthy banks that have insufficient funds and no place else to borrow them at the end of the day. This prevents our hypothetical Bank A from closing out the day insolvent.

Serving as a guarantor of payments and lender of last resort contains one threat to the stability of the banking system, but like deposit insurance, it also creates the incentive for individual banks to take on too much risk. Banks know that if, at the end of the day, a bank does not have sufficient funds to make its payments, the Fed will step in and provide the necessary funds. So, banks do not concern themselves as much as they should about their reserve position or the positions of the banks from which they are collecting payments.

Again, with marketplace oversight of risks neutralized, bank regulators and supervisors must step in to ensure that banks are properly limiting their risk positions. Therefore, it takes a combination of serving as payments guarantor, lender of last resort, and bank regulator for the government to bring greater stability to the banking system, despite banks' interdependence in payments.

So, yes, bank regulation does help bank customers — and in a way that one does not always think about — by helping to ensure the stability of the banking system.

A stable banking system benefits more than just bank customers — it is an essential element of a strong economy. It helps gather people's savings and channel them to the most productive investment opportunities available. That kind of investment in new equipment and new technologies is an essential engine of growth and rising standards of living. Indeed, improving overall economic performance is government's ultimate purpose in building the banking infrastructure that it has over the past century.

DO BANK CUSTOMERS NEED SPECIAL PROTECTION?

So, we might pose the following question. Suppose the banking industry is operating with government-provided deposit insurance, payments guarantees, and lending facilities. Further suppose that supervisory and regulatory mechanisms are in place to manage the risk exposures that these programs create. Finally, suppose that within this environment, banks are free to offer any financial service, serve any market segment, and charge any price. Would a "free market" serve bank customers' interests best, or would such a marketplace be inimical to the interests of bank customers?

This is not an easy question to answer. Today, most people would lean toward the first view. Given that the market for financial services is an intensely competitive one, banks have

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strong incentives to deliver at fair prices a broad array of products and services that effectively meet the needs of their diverse customer base.

Historically, most people, including researchers, politicians, and policymakers, were not always of this opinion. During the 1930s, in the midst of the Great Depression, people leaned heavily in the other direction. The thinking was that there existed substantial need for rules and regulations to protect bank customers from the unbridled workings of the marketplace, which included both monopoly and customer exploitation.

As you might imagine, the truth lies somewhere in between these two views. Indeed, the history of banking legislation and the regulation of banks over the past 75 years has been essentially a story about finding that

middle ground. Legislation passed in the 1930s made banking arguably the most heavily regulated industry in the United States. Gradually, we have been dismantling the unnecessary, burdensome, and even counterproductive regulations that have thwarted the legitimate workings of the marketplace. At the same time, we have been trying to devise regulations to eliminate the genuine flaws in the marketplace that create opportunities for exploitation or abuse.

ELIMINATING DYSFUNCTIONAL REGULATIONS

However, this middle ground is hard to find and harder to tread. But we can find some lessons in the mistakes and successes of the past. Perhaps the clearest is that regulators can achieve their goals only if they respect the power of the marketplace.

There are clear-cut cases of bank regulations that failed to achieve their intended goals because regulators failed to take into account the market forces at work and the capacity of bankers, and occasionally consumers, to innovate around a regulatory barrier when it is in their interest.

Attempts to regulate market prices — or, in the case of banking, market interest rates — offer an instructive example. Under Regulation Q, the Fed was authorized to set ceilings on the interest rates that banks paid on their deposits. The intention was to supply banks with funds at relatively low cost and thereby hold down interest rates on bank loans, particularly residential mortgages. But in the 1970s market interest rates on other savings instruments rose above the Reg Q ceilings, and the result was a reduced supply of funds to banks and a harder

time for mortgage borrowers. Savers withdrew their bank deposits to buy higher yielding assets. Meanwhile, potential mortgage borrowers found their options reduced and their local bank in dire financial straits.

Not long after, some state banking regulators tried to impose usury ceilings, or interest rate caps, on consumer credit, including installment loans and credit cards issued by banks operating in their jurisdictions. The intention was to make credit available to state residents at lower interest rates. However, the providers of consumer credit skirted the regulation. They simply ceased issuing credit in those states and moved to states where usury ceilings were not in force. The financial activity in Delaware is a testimony to banks' ability to shift operations to more friendly terrain. Delaware is now home to nearly half the credit cards issued in the U.S.

As these attempts to regulate market prices and other examples of restrictions on product features, organizational structure, or market geography show, regulation will not deliver the intended result unless that result serves the interests of those on both sides of the market: bankers and their customers.

Over the past 20 years, in particular, we have acted vigorously to remove the rules and regulations that stifle competition and innovation. The Depository Institutions Deregulation and Monetary Control Act of 1980 eliminated many restrictions on banks' pricing and product offerings. Next, limitations on banks' market area were set aside. The Garn-St. Germain Act of 1982 allowed bank holding companies headquartered in one state to acquire banks in other states. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 permitted banks headquartered in one state to open branches in other states if permitted by state law.

This process of deregulation brought positive results. It intensified competition among banks, inducing them to expand product offerings, increase efficiency, align prices with production costs, and improve service to their target customers.

Recently, the string of pro-market legislation culminated in the passage of the Gramm-Leach-Bliley Act, also known as the Financial Modernization Act of 1999. This act repeals the long-standing Glass-Steagall Act of 1933 that had prohibited banks from affiliating with securities firms and insurance companies. Under Gramm-Leach-Bliley, banks, insurance companies, securities firms, and other financial institutions can affiliate under common ownership and offer their customers a complete range of financial services.

The ultimate impact of Gramm-Leach-Bliley is yet to be realized. Will people want one-stop shopping for financial services at a financial "supermarket"? Or do they prefer shopping in a financial services "mall," purchasing services from a variety of different specialized providers? With the presence of both big institutions and niche players, people have a choice. Probably, both types of institutions will do well because consumers' tastes and preferences are not uniform. The virtue of the current structure is that the mix of suppliers in the financial services industry will be determined by consumer preferences.

DEVISING REGULATION THAT OVERCOMES MARKET FAILURES

This is not to say that the banking marketplace functions perfectly and there is no need for regulations aimed at helping bank customers. Regulators' primary focus today has shifted away from product and price restrictions and toward improving the quality of market information available to consumers.

For any market to function properly, those buying the good or service must fully understand their choices, what they are buying, and what they are not. In the marketplace for financial services, this is a challenge. Financial products and services have many complex features, and innovative financial firms armed with the latest in information technology are creating more sophisticated products and services all the time.

To help consumers make more informed choices, regulators have pushed for greater clarity in loan documents and financial disclosure statements. The first step was to standardize the information on disclosure forms. Truth-in-Lending and Truth-in-Saving regulations are two classic examples.

Truth-in-Lending establishes a standard formula that lenders must follow in disclosing the interest rates and fees they will charge on a particular loan. The regulators' aim is to give consumers the information they need to do some "comparison shopping" when they look for a loan. Truth-in-Saving does the same thing for investment products.

Have these regulations worked? The fact is that the required disclosure forms have been attacked from both sides. Lenders claim the disclosure statements are expensive to produce. Consumer advocates argue that they are imprecise and difficult to understand. Both sides have valid points, but these are issues about particulars. Such disclosures are steps in the right direction, and regulators should work to refine and improve them.

But we must go beyond improved disclosure statements for the banking marketplace to function smoothly and deliver maximum benefit to all its potential customers. We must build consumers' understanding of the workings of the financial system so that

their level of financial literacy is commensurate with the sophistication of today's financial marketplace.

In the burgeoning subprime lending market, where concerns about predatory lending have sprung up, we see some momentum toward increasing financial literacy today.

REGULATION AND DEREGULATION GIVE RISE TO SUBPRIME LENDING MARKET

While the subprime lending market is relatively new, it has had a fairly long gestation period. When the banking marketplace was heavily regulated, banks allocated consumer credit sparingly. Good or "prime" borrowers received credit; others did not. In the early 1970s, legislators and regulators wanted to ensure that banks provided equal access to credit for all segments of their market area, including low- and moderate-income communities. The Community Reinvestment Act and associated regulations encouraged banks to target bankable assets in these previously untapped market segments, essentially extending credit availability down-market. Lending volumes grew rapidly in this area, and bankers became more familiar with the lending opportunities available.

Initially, banks were able to charge high interest rates to these new borrowers. But, in recent years, as deregulation and innovation have intensified competition among banks and other financial service providers, those interest rates have declined substantially.

This is not to say that the interest rates on subprime loans were driven to equality with the rate on prime loans. However, the interest rates banks charged and the amounts they were willing to lend to subprime borrowers reflected a reasonable assessment of the higher loss rates and differential risk involved. In short, a reasonably well functioning subprime lending market

has been established. The initial impetus, which came from legislators' and regulators' imperative that banks expand access to credit, was largely successful.

PREDATORY LENDING

But along with these positive developments in subprime lending have come alarming incidents of abusive practices by some lenders operating in that market. These practices — often targeted at elderly women and minorities — are commonly referred to as predatory lending.

Clearly, the best way to eliminate predatory lending is to eliminate the information asymmetry that gives rise to it.

As the competition drove banks and other lenders to expand the subprime market, credit was made available to more people relatively unfamiliar with the financial marketplace. As research done by groups like The Reinvestment Fund in Philadelphia shows, the sad truth is that some unethical lenders take unfair advantage of the situation, exploiting customers' naivete and convincing them to take on mortgages with onerous, and often unrealistic, terms, charging excessive fees or exorbitant interest rates, rolling in hidden costs or unnecessary insurance, or simply committing outright fraud.

The root cause of predatory lending is, of course, the differential level of knowledge between the lender and borrower — an extreme case of what economists call "information asymmetry." It is difficult enough for mainstream customers to understand and choose wisely from among the many complex financial products and

services offered today, but it is an exceptionally daunting challenge for those with limited financial experience or education to make such decisions.

In addition, low-income people usually have limited access to long-term credit and can ill-afford to keep money on hand. Consequently, they are receptive to a sales pitch offering upfront cash and a long payback period. And when an unexpected expense comes along, the need for immediate cash makes them easy prey for the predatory lender.

I want to reiterate that subprime lending is by no means synonymous with predatory lending. Subprime loans carry a higher interest rate because they carry a higher risk of default. This makes perfect sense in a competitive market where expected loss and risk determine price. Predatory loans carry disproportionately high interest rates or onerous terms not justified by higher risk. Rather, these rates or terms are imposed by lenders willing to exploit a borrower's lack of financial knowledge, market access, or economic resources.

It is important for regulators to make this distinction because we want to put an end to predatory lending without otherwise impeding the workings of the subprime lending market. How do we accomplish this?

Tempting as it may seem, I doubt that the solution lies in imposing interest rate ceilings or outlawing certain terms on loans, given our previous experience with interest rate ceilings. Our intention would be to get better terms for victims of predatory lending. Instead, we would likely shrink the pool of funds now available to high-risk, low-income consumers in the subprime lending market. And the victims of predatory lending would likely be no better off — their economic and financial circumstances would not change.

Clearly, the best way to eliminate predatory lending is to

eliminate the information asymmetry that gives rise to it. Consumers who understand basic personal finance, are willing to explore their options, and know how to exercise their contract rights are less likely to be victimized.

Efforts to advance financial literacy are booming. In Philadelphia, for example, the Neighborhood Reinvestment Corporation, a publicly funded organization with a solid reputation for its community information and counseling programs, is starting on a new project to educate low-income people about home mortgages. Meanwhile, at the national level, the American Bankers Association has formed a working group to educate bankers and community leaders about predatory lending.

We at the Federal Reserve are doing our part to foster greater financial literacy by providing materials and supporting local efforts through our Community and Consumer Affairs Department. The Fed continues to pursue basic research into the financial behavior of consumers at all income levels, so that we can better understand how and why they use the financial system as they do.

My reading of the evidence from Fed research and elsewhere is that

the need for greater financial literacy extends well beyond that of low-income people or other relative neophytes to the financial marketplace. People generally know relatively little about the financial marketplace. Even regular consumers of various financial services do not really understand the costs and benefits of their choices.

CONCLUSION

Let me conclude by returning to the question with which I began: Does bank regulation help bank customers? In some cases, my answer is a clear yes, though perhaps not in the way one might at first think. For the nation to have a sound and stable banking system, the government must absorb some of the risks inherent in the system. In the United States, the government does so by serving as deposit insurer, payment guarantor, and lender of last resort. Having absorbed these risks, the government must regulate and supervise banks to ensure they do not introduce new ones. So bank regulation is part and parcel of having the sound and stable banking system that bank customers in the U.S. enjoy.

In other cases, my answer is a clear no. Regulations that do not take into account the self-interested reac-

tions of market participants — both bankers and bank customers — will not serve bank customers or achieve any other regulatory goal. At best they will have no effect; at worst they will produce unintended and deleterious consequences.

Finally, in some cases, my answer is maybe. In principle, bank regulations can help bank customers if they increase the degree of competition or the flow of information in the marketplace and thus drive suppliers to do a better job of meeting their customers' demands. But in practice, regulations designed to improve the quality of information, such as Truth-in-Lending or Truth-in-Saving, have met with mixed success at best.

Recent developments in the subprime lending market, particularly the egregious episodes of predatory lending, deserve regulators' serious attention. I believe that the most effective and lasting solution to this problem lies not in regulation but in education. Given today's fast-growing, complex, and sophisticated financial marketplace, raising the general level of financial literacy among consumers may be a more productive use of public resources than any new regulatory initiative. 