Chapter 9
Policy Issues

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The financial service industry is enjoying a period of rapid innovation in supporting technologies. The effort to use those innovations to best advantage is contributing to rapid changes in the structure of the industry and in the services it offers. On the one hand, technology motivates change; on the other, facilitates it.

Through the applications of technology, the financial service industry provides the public a choice of modern and efficient services more diverse than was available in the past. From another perspective, the introduction of explicit pricing for services, the increased complexity of the menus offered and other effects following from the introduction of technology are not amenable to all users.

Changes in basic social institutions almost invariably raise questions for public policy. The basic tenets that comprise the foundations of existing policy may no longer hold; or, if they do, the existing means of realizing established goals and objectives may no longer be workable. Relationships between and among individuals and institutions may be altered in ways that make some relatively worse off while others become relatively better off. The results of such shifts can be political pressures for new or modified policy goals and mechanisms for achieving them.

Information technology has made it easy to bypass some legal and regulatory provisions. Some new services or altered service packages are being delivered through systems that did not exist when regulatory provisions were written, and some services are offered by institutions not covered by the provisions.

It is likely, therefore, that some of these provisions now only burden the industry unnecessarily, cause unplanned distortions in the market, or place some financial institutions at an unreasonable disadvantage. The very scale and rapidity of the changes and the fluidity and turbulence in the environment within which financial institutions are now operating could cause excessive risk for these organizations and their customers. It is also possible that some of the ends sought in existing laws are no longer appropriate or useful.

Formulating policy issues and options with regard to these changes meets with one immediate and serious challenge. Changes are coming about so rapidly and in so many diverse directions that it is difficult for financial institutions themselves or for outside observers to anticipate the patterns that will eventually prevail.

Nevertheless, it is possible to foresee some of the broad patterns likely to emerge and to anticipate in a general way their likely consequences. It is important to do so because policy decisions made or avoided now may have far-reaching consequences. For example, some potential benefits of the new technology may not be realized. Costs and benefits may be inequitably distributed. Unnecessary burdens may be imposed on industry or on consumers. Civil rights and liberties may be compromised.

Policy is promulgated through legislation and regulation; it can also be imposed through less formal, political activities such as Presidential “jaw-boning.” Policy alters market forces and the relative power of the factors that determine price and product mix. For example, limitations on interest rates led to bundling of financial services which, in turn, resulted in cross subsidies. Services could then be provided to some who could not have afforded them had they been required to pay prices based on a true allocation of costs. Now, technology, combined with other forces, is creating an industry structure that explicitly charges for services on the basis of fully allocated costs. Some people may not be able to afford them. If this is judged contrary to the larger public good, it becomes the task of the policymaker to adjust those circumstances through carefully designed policies.

Thus, even though significant uncertainties about the future remain, it is essential that an assessment of the implications of advanced technologies for the financial service industry be made. Many of the policy issues discussed below are not new. Competition and consolidation, fair play, privacy, and security have always been concerns in financial service delivery, even with older paper-based technology.

To identify the public policy issues related to financial services it is necessary to look more closely at relationships between financial services and broad national objectives that reflect various public interests in those services.

Public Interests in Financial Services

Some of the major laws and regulations related to financial institutions express explicitly and implicitly national objectives related to financial services. There is a strong public interest in the maintenance of financial institutions that will:

- assure and facilitate transactions necessary for a strong and growing level of economic activity in the Nation and in all regions and communities;
- encourage savings and capital formation;
- protect the savings and investment of individuals, families, businesses, and social institutions;
- avoid excessive concentration of economic and financial resources; and
- support and strengthen the competitive position of the United States in world trade.

implicit in the concept of the public interest are also the basic national objectives of national security, equal treatment under law, and a host of well-established civil rights and liberties. Therefore, financial service systems should:

- not compromise national security, or the ability of the Government to implement foreign policies;
- not adversely affect the exercise of civil rights and liberties; and
- not discriminate against some people by depriving them of necessary financial services or placing an unfair burden on them in using those services.

There are also specific Government concerns and interests in financial services. Because Federal, State, and local governments are major users of financial services, they have a special interest in efficiency, low cost, and security in making and receiving payments. For example, the U.S. Department of the Treasury wants to move toward direct deposit of all Federal payments to reduce the costs of this huge volume of transactions.

Finally, the degree to which the introduction of advanced systems for delivering and using financial services may affect the ability of government to use monetary and fiscal policy as tools for ensuring economic stability and growth remains unknown. The increase in transactions and income velocity as a result of this technology could make it more difficult to intervene in unsatisfactory general economic conditions through instruments of monetary policy. Use of information technology, by changing the velocity of money, changes the effective stock of money in the economy at any one time. Technologies can facilitate the delivery of services that effectively monetize assets that in the past were considered illiquid (e.g., the ability to draw on home equity as a line of credit). This could complicate attempts to use monetary policy to reduce inflationary pressures or to stimulate stagnant conditions, although what the effect will be in practice is far from certain. At least, it will be more difficult to define or estimate the stock of money. The speed of transactions will cause the consequences of policy interventions to be felt more rapidly, which could be both beneficial and risky—under the worst possible scenario, it could lead to economic fibrillation.

Possible Changes in the Structure of the Financial Service Industry

Information processing and telecommunication technologies, as applied to financial services, have seven direct and significant effects:

1. They remove geographic and temporal constraints on the delivery of financial services and allow them to be delivered from remote locations and to new and widely dispersed locations, such as homes and offices.
2. They allow transactions to be completed almost instantaneously, increasing the velocity of money in the system.
3. They facilitate complex networks and interrelationships between institutions, markets, and geographical areas.
4. They provide the flexibility for many alternative combinations of services and service features, allowing both "bundled" and narrowly targeted services.
5. They improve productivity and, in general, lower the costs of providing services.
6. They increase the capitalization of financial services, providing opportunity for new providers of intermediate and shared facility services to financial service institutions.
7. They create the possibility of electronic legal tender and the opportunity to monetize a wide variety of assets.

Current and anticipated changes in the structure of the industry and service delivery mechanisms, assuming no interference with present trends, include:

- Increased diversity in the nature of institutions within the industry, in which traditional categories of depository and nondepository institutions are no longer sharply delineated and in which the line between financial and nonfinancial institutions, as defined by products and services, is blurred.
- Development of large, diversified financial institutions offering a wide range of retail services and service locations so that users may have many financial relationships with the same institution.
- Some vertical as well as horizontal integration as diversified firms acquire the internal capabilities to perform functions for which they previously turned to the wholesale market.
- Development of many small, highly specialized institutions that target narrow markets and specified groups of clients.
- Continuing mergers and a trend toward absorption of middle-sized institutions, especially those having a strong local or regional orientation.
- Rapid product proliferation-i. e., proliferation of services that are functionally similar but differ in regulatory restrictions and interest rates and in the distribution of responsibility or risk between providers and users.
- Greatly increased functional integration of the national financial service industry through technological networks and institutional relationships.
- Great reduction in the significance of time of day and location in delivery of financial services.

In developing national policy about financial services, policymakers should take into consideration six critically important questions:

1. What national objectives should be sought in framing policies related to financial services?
2. Is there a need for a thorough restructuring of the regulatory system as opposed to marginal corrections?
3. How much competition is appropriate and desirable in this sector of the economy?
4. What institutions or services is it essential to preserve and for what purposes?
5. What is the appropriate level of risk for providers and users of financial services to assume, and how should that risk be distributed?
6. How can the financial service industry support a strong U.S. role in the world economy?

Generic Considerations in Framing Financial Service Policy

In the sections that follow, salient policy questions pertaining to the financial service industry are presented, and some of the alternatives for dealing with them identified. The first group includes two broad general questions, the second deals with issues related to industry structure, and the third discusses risk allocation issues.

General Policy Issues

Issue 1: What are the alternative approaches that could be used if a review and restructuring of laws and regulations related to financial services were undertaken?

Information processing and communication technologies have already had a profound effect on the handling of financial data. The capabilities that these technologies offer—efficiency, speed, integration of activities over a wide area, flexibility, and networking-are powerful. Because these technologies change both the way data is handled and the way funds are transferred between competing uses, they affect the allocation of resources in a dynamic economy. Moreover, the technologies will continue to develop rapidly and probably in unforeseen ways.

Some argue that, just as the effectiveness of many laws and regulations has already been significantly diminished by information technology and associated structural changes in the industry, any regulatory revisions made now will also be subject to rapid obsolescence, as new technological capabilities are developed.

But piecemeal revision is in fact well underway. The question is whether it should continue to be done in bits and pieces, lagging behind and reacting to changes; or whether a new system of laws and regulations should be designed to guide and control future changes?

Two of the most recent pieces of legislation were developed in reaction to changes that had already occurred in the market. The Depository Institutions Deregulation and Monetary Control Act of 1980 was partly motivated by a finding of the courts that the deployment of automated teller machines (ATMs) by thrift institutions violated existing law. Offerings of zero-balance checking accounts by commercial banks and other newly developed services also challenged the existing legal regulatory structure. If Congress had not acted, significant investment in advanced equipment and services that had proved attractive to consumers would have had to be abandoned. The Garn-St Germain Act of 1982 was passed in part because the rise in short-term interest rates had caused funds to shift out of depository institutions to money market funds and had thrown the cost of liabilities and the earnings of assets held by the thrift industry so far out of balance that the viability of these institutions was threatened.

The rate of change in the financial service industry has not abated since the passage of this legislation. There is every expectation that coming years will see changes occurring at an equal or faster rate than that of the recent past. Financial service providers will continue to rely heavily on technology to work around policies they believe limit their ability to operate effectively in a changing environment.

Policy Options for Issue 1

Congress has two options:

1. Continually fine tune the legal/regulatory structure to account for short-term changes and trends in the forces that shape the financial service industry.
2. Undertake a fundamental redesign of the policy structure governing the financial service industry.

Option 1: Continue to modify existing legal/regulatory structure to reflect short-term changes.

This course reduces the possibility that there will be an abrupt change in the operations of the financial service industry. Congress would continue its ongoing oversight of the financial service industry and continually fine tune policy to meet the needs of evolving conditions. However, congress may find itself trying to mitigate the undesirable effects of change after the time has passed when preventive measures might have been taken. Also, the structure that may result from this approach is likely to become so complex and cumbersome that it will hamper the efforts of the financial service industry to serve the needs of the Nation.

Option 2. Undertake a fundamental redesign of the policy structure.

Congress may choose to step back from the problem, the changes that have taken place in the conditions that shaped existing policy, and formulate new policies. Such a policy structure, because it would be coherent in its treatment of the elements of the market and the industry and clear in its concepts of national needs and the public interest, is likely to be more robust in the face of future change than policies developed incrementally.

A comprehensive review and reformulation of the policy structure governing the financial service industry will require time; and the rate of change in the industry will not abate while new policies are being formulated. Ongoing events will require response and divert attention from the long-term perspective. The task is difficult but, realistically, doable.

Issue 2: What are the mechanisms available to Congress for implementing policy pertaining to the financial service industry?

Specifically, how should tradeoffs be made between the objectives of maximum economic efficiency, protection of local interests, and other social objectives?

Policy Options for Issue 2

Congress has three broad options:

1. Continue relative deregulation or market-determined solutions by continuing to relax constraints on the industry and by taking little action to neutralize events taking place in the market.
2. Deregulate, taking into account the factors that have changed the effects of various provisions of the old structure on providers and users of financial services.
3. Instead of comprehensive regulation of most services, establish compensatory programs that work through the marketplace to bring about conditions deemed desirable. (Organizations such as the Federal Home Loan Mortgage Corporation and the open market operations of the Federal Reserve serve as precedents for this alternative.)

Option 1: Continue deregulation.

Congress may conclude that maximum economic efficiency, both in delivering services and in using those services to direct funds to productive uses, is necessary to support a rising level of economic activity. If Congress also concludes that the best way to assure this efficiency is to free the financial service industry to respond sensitively to market forces, then it may opt for further deregulation.

The industry, if allowed to follow the path it is now on, will effectively become less regulated over the next decade. Much of the major legislation focusing on depository institutions and investment banking has already been neutralized by events or has been revised to accommodate past changes. Major new entrants in the financial service market operate outside the purview of the existing regulatory structure. Some States have taken actions that further reduce the effectiveness of existing Federal legislation.

It is necessary to remember, however, that deregulation at the Federal level will in all likelihood result in greater diversity in State regulatory strategies. This lack of consistency could itself introduce inefficiencies in the financial service sector. The patchwork of State regulation has already posed difficulties for those that want to deploy regional and nationwide ATM networks. Institutions now seek to establish portable activities such as credit card processing in States that permit them the greatest freedom. This will affect the market by introducing inefficiencies in allocation of financial resources and service delivery mechanisms and could result in a mix of financial service products in some States that is qualitatively different from that available in other States.

The number and diversity of options available to users will increase and will be fully adequate to sustain and promote a healthy overall level of economic activity in the Nation. However, the benefits of these services may carry some risk of pulling financial resources away from some local communities and of compromising some socioeconomic objectives. The general effect will be to shift financial resources toward their highest economic use without regard for social values. There is, for example, some possibility that funds will drain from regions or communities in economic distress or with a less attractive balance between risks and return than other regions. Large national institutions may be less interested in community needs than small local banks. Banks are required, under the Community Reinvestment Act, to give high priority to meeting the needs of their communities, although there has been little pressure to do so. Other kinds of financial institutions do not have this requirement. Unless ease of entry for new competitors continues and the market opportunities are sufficiently attractive to draw them in, local needs may go unmet, and Congress will then be faced with the need of rectifying inequities.

Alternatively Congress could limit the percentage of loan capacity that a financial institution makes available for national and international use. The highest economic use for resources is not always the same as the highest social priority. An adequate supply of housing and opportunities for home ownership are, for example, generally accepted as national policy objectives. So, too, are protection of small farms and small business opportunities.

Under strong competitive pressures, helped along by rate fluctuations and a tight money supply, money may tend to move away from long-term, fixed-interest loans, such as mortgages. This could have significant detrimental impacts on the supply and cost of housing, the construction and real estate industries, their suppliers, and government housing programs unless alternative loan instruments are developed. Money may also be funneled away from loans for local entrepreneurs and small businesses and from rural banks that supply seasonal loans to farmers.

On the other hand, as financial resources are drawn into high-growth areas, they will tend to moderate interest rates and have a stabilizing effect. This would continue the function of redistributing financial resources that has been historically performed by the financial service industry.

Thus, policies that encourage highly competitive national money and capital markets may produce significant economic benefits, even though there is a potential penalty in terms of limiting the funds available for social programs that have been considered to have high social value but produce little tangible product.

Option 2: New *regulations.*

If, on the other hand, Congress chooses to develop a new regulatory structure for the financial service industry, it will be faced with the formidable task of identifying a set of policy variables that will be comparatively insensitive to changes brought about through the operation of market forces coupled with the influence of technological change. Some have suggested, for example, that regulation be by function, as is the case with the Fair Credit Reporting Act, which places specific requirements on all who offer credit to the public. Others believe that regulation by specific product would be appropriate. For example, any provider could offer a federally insured account as long as specific criteria with respect to reserves and auditability were met. Still others would continue the regulatory focus on institutions, and others would focus on the systems used for delivering services. Some combination of these approaches could be viable. Each has its strengths and weaknesses. None would be simple to develop, and all would be difficult to insulate from the kinds of changes now taking place and those expected in the future.

Option 3: No *comprehensive regulation; instead, active Federal role in marketplace.*

Finally, Congress could establish a role as an active participant in the marketplace for the Federal Government. It could, for example, provide payment services for areas abandoned by firms in the private sector. It could enter the financial markets, as it now does in the case of mortgages and student loans, to assure the availability of funds for socially worthwhile products. As noted, market intervention of this type has a precedent and does not put the Government in the position of having to anticipate the specific effects of technology and market forces on the availability of capital and on the accessibility of services to the public. Such a policy would be robust. It could, however, add substantially to budget deficits.

At a minimum, some Federal presence beyond an insurance program to ensure the safety and soundness of the financial service industry is likely to be required. But a debate such as the one about the Federal Reserve as a provider of financial services is likely to develop and intensify over time whenever Government actions encroach in areas the private sector feels it can serve adequately. Also the Government may not be able to adjust rapidly enough to changes in market conditions to react in a way that does not introduce instabilities into the marketplace.

Structural Issues

Issue 3: What levels of concentration in the financial service industry **are** consistent with the goal of preserving competition among providers of financial service?

One of the fundamental objectives in financial service policy has been to prevent the excessive concentration of economic and financial resources in relatively few powerful organizations. This has, for example, been the motivation for prohibitions on interstate banking and intrastate branching, for preserving the unique role of banks by limiting their activities, for insisting on sharp separation between categories of financial institutions, and for controlling interest rates according to the type of accounts covered. These provisions were in part to protect smaller or specialized institutions, especially local institutions, against unfair competition from very large institutions and in part to maintain a diversity of niches within which competition could flourish.

These regulatory strategies have been overtaken by the use of information technology that destroys the advantage of proximity, allowing institutions to share data banks and delivery mechanisms and by institutional relationships that ignore both jurisdictional boundaries and regulatory definitions of institutional categories. The new technology also has paradoxical effects on economies of scale. To compete in a national money market, an institution must offer its services to a wider market, deliver them without regard to the location of the user, and support these activities with a large volume of transactions. On the other hand, through access to shared networks and wholesale support services, even very small institutions can now enter and remain viable in local markets.

Regulatory strategies have already been modified to respond to these economic and technological pressures, but on a piecemeal basis. As a result, traditional financial institutions are fiercely competing with one another and with new organizations, including nonfinancial institutions, that are entering their markets. It is not clear how existing antitrust tests apply to this sector in these circumstances, since it becomes progressively more difficult to define markets. It is clear, however, that in spite of–or because of–the fierce competition now underway, the potential exists for increased concentration of financial resources and for the development through repeated mergers and acquisitions of large organizations with excessive size or power in financial markets.

It is possible that the kind of competitiveness that was desirable in the past, as measured by the number and size of institutions and the scope of their markets, is no longer appropriate in view of several changes:

- the increased size of the population,
- the increased level of U.S. economic activity,
- the increased size of industrial markets,
- the increased scale of commercial organizations,
- the increased volume of international trade,
- the increased diversity of services,
- the redefinition of the roles of financial institutions, and
- the decreased advantage of proximity for users of financial services.

Congress will want to consider in the context of these changes whether intense and increasingly uncontrolled competition will work to the detriment of some important segments of the industry, will encourage financial institutions to take excessive risks, or will result in harmful consolidation of economic and financial power.

Policy Options for Issue 3

Option 1: Allow market forces to continue as a primary determiner *of the* evolutionary *path for the financial service industry even though they may create major consolidated, national services organizations.*

As long as entry barriers remain low, small firms are likely to appear on the scene to meet local needs. If banks remain subject to special restrictions, they will be at a competitive disadvantage relative to other kinds of financial institutions in operating in the national market. Continued reliance on existing antitrust legislation to prevent excessive concentration of financial power would face increasing difficulty in defining markets and market participants for the purpose of antitrust enforcement actions.

Option 2: *Define criteria under which mergers would permitted and firms would be allowed to enter or leave a market.*

Again, with this option, it would be difficult to define market boundaries for the purpose of evaluating adequacy of competition following a merger. Problems of defining minimal services levels and alternatives for meeting them would have to be resolved before decisions on permitting firms to exit a market could be made. Unless the law were structured to prevent it, unregulated services providers would continue to use new technologies to enter the market outside of the existing regulatory structures. Such entrants would affect the competitive balance in a market and would be free to exit even though the result would be a level of service that falls below acceptable minimums.

One or more organizations, public or private, could be assigned the role of provider of last resort to fill voids in the availability of financial services. However, regulators would then be faced with the problem of determining when alternative suppliers have, in fact, abandoned a market, making it necessary to call on such providers.

Option 3: Highly regulate only a specific set of financial services.

The model of the telecommunication industry could be followed, in which a specific set of financial services such as deposit-taking would be highly regulated. Competition in these product areas would be tightly controlled and maintained so that the market could not be controlled by just a few firms. All other financial services could be offered by almost any type of institution in a virtually unregulated market. The regulated financial service institutions could offer unregulated products only through arms-length subsidiaries so that there would be no cross-subsidization between regulated and unregulated services. This approach would have the advantage that those financial services where safety and soundness is of greatest concern would be tightly controlled, and competition would be preserved. But the fact that technological means would almost always be found to bypass any boundaries that might be drawn between product areas suggests that this approach will be difficult to implement.

The definition of basic financial services—those to be regulated-and the identification of those offering them would be difficult. Service providers would, using innovative information technology, tend to design services that closely approximate but are not technically identical to regulated services and to offer them in the unregulated market. There would be *no* guarantee of adequate competition in the unregulated markets, and antitrust laws would provide the only means through which excessive concentration of financial power could be prevented.

Issue 4: What modifications, if any, could be instituted regarding restrictions on interstate banking?

Restrictions on interstate banking were intended to prevent financial resources and control over credit from becoming progressively consolidated in a few powerful institutions. They were also meant to maintain a local orientation and interest and to preserve for consumers the convenience and access afforded by proximity to financial services. Lately, these restrictions have been in large part rendered ineffective. The sharing of ATM networks allows some banking functions to be carried out from remote locations. Some banks, with regulatory approval, have bought banks and savings and loan associations in several States. Nondepository institutions offer services nationwide that are perceived by users as functionally equivalent to traditional bank accounts. Regional and national networks have made proximity to the service provider no longer a necessary measure of convenience for the user. However, restrictions on interstate banking still place banks at some disadvantage vis-`a-vis other financial institutions. For example, facilities to accept demand deposits generally are not placed across State lines, but corporate clients are provided this service indirectly by means of zero-balance accounts linked to consolidation accounts in another State. Interstate banking restrictions have probably protected some inefficient institutions that would otherwise have been driven out of the market.

Policy Options for Issue 4

Option 1: Remove or modify restrictions on interstate banking.

Congress could act systematically to remove all remaining restrictions on interstate banking. To do this would require Federal legislation repealing the interstate banking prohibitions in the McFadden Act and the Bank Holding Company Act, thus withdrawing Federal consent to State statutes Mocking in-

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terstate commerce. The overall effect would be further dissociation of financial service institutions from orientation toward a particular community, market, or region, and further integration of a national financial service market. Removing restrictions on interstate banking would tend to strengthen a trend toward consolidation, since some financial institutions would probably not survive competition with large national firms. On the other hand, it is possible that financial services might be extended to some now underserved or isolated communities from depository institutions in neighboring States.

Congress could, by amendment to the McFadden and Bank Holding Company Acts, modify restrictions on interstate banking to allow and encourage areawide banking in multistate metropolitan areas, or regional banking in multistate market areas (as is already done in New England under an interstate compact).

Option 2: Reinforce limitations on interstate *banking.*

Alternatively, Congress could strengthen restrictions on interstate banking by removing all loopholes. The Federal Reserve has just moved to plug one loophole by redefining commercial deposits to include NOW and Super NOW accounts. Following the reasoning that led Congress to pass legislation legitimatizing ATMs deployed by savings and loan associations after the courts had declared them illegal, it does not appear feasible nor desirable to dismantle interstate ATM networks or to prohibit the cash management programs offered by brokers. It would be possible to extend reserve requirements to all institutions that operate depositlike accounts, including securities dealers. This might, however, imply giving all of these institutions access to the payments system or to deposit insurance.

One possibility is to establish rigid criteria for entry to and exit from the market, including criteria for permitting mergers. But, such criteria would be hard to define and enforce because institutional boundaries and product lines have already become so blurred. Criteria would have to be defined in terms of market share or in terms of control over deposits or total assets. Given the heterogeneity and fluidity of the industry, this would also be hard to do.

Other possibilities are to continue to prohibit holding companies from owning depository institutions in more than one State, as was the case until the 1980's, or to subject all depository institutions to a rigid prohibition on interstate banking, which would require preemption of State laws and extension of relevant Federal laws to cover savings and loans and credit unions.

Some way might be found to strengthen and broaden the Community Reinvestment Act, possibly by requiring local development loans at a level pegged to the level of deposits gathered from an area. This would be a factor limiting the flow of funds out of the areas generating them.

Issue 5: How might law and regulation be used to focus the attention of various classes of financial service providers on specific market areas?

Federal policy since the 1930's has allocated specific functions to specific financial institutions. But recently, a combination of technological innovations and market forces has significantly weakened the functional distinctions between types of financial institutions. This condition has developed gradually, with few of the steps along the path involving positive decisions by policymakers. It may be appropriate now for Congress to reexamine the question of whether public interests still require the limiting of some roles and functions to a special category of financial institutions.

Banks and thrifts are unique institutions be cause they alone have access to the payment system. Funds are transferred from one account to another only within banks. All transactions not carried out by exchange of currency (except for some internal clearing) are ultimately culminated within the banking system, and all financial institutions must ultimately call on a bank for the final step in delivering a service. Banks also allocate credit by making and guaranteeing commercial loans.

Because of this dependence, the safety and soundness of banks-and public confidence in them—are an essential underpinning of the economy. National policy therefore has always been to treat banks differently from other kinds of financial institutions and to prohibit them from engaging in other kinds of commercial activity. Specifically, the goals of this policy have been to:

- insure the soundness of banks (originally the purpose of both reserve requirements and depository insurance);
- limit the risks that banks could assume;
- prevent conflicts of interest, such as would occur if banks directed investment to or allocated credit to commercial activities in which the bank had an equity interest, or if banks required borrowers to purchase insurance underwritten by the bank; and
- prevent concentration of financial resources by forbidding banks to participate in certain kinds of investment activities, such as underwriting stock issues and casualty or life insurance.

Other financial institutions, and in some cases nonfinancial institutions, are now encroaching on activities once limited to banks —i.e., offering accounts that consumers perceive as functional equivalents of depository accounts but with the advantage of higher interest rates. Nondepository institutions are buying banks, gaining access to the payment mechanism through them, and acquiring their assets and customers, They are then abrogating one or more of the two functions that define a bank (i.e., accepting commercial deposits, making commercial loans) in order to escape Bank Holding Company Act prohibitions on nonfinancial activities.

Banks and bank holding companies, in retaliation, are seeking to expand into other services, for example, offering insurance in States where laws permit and increasing their offerings of data processing services. Low-cost or free deposits, the traditional source of funds for banks, are drying up as corporations practice zero-balance banking and savers transfer their money to higher interest accounts and money market funds. This forces banks to try to expand their customer base by offering a greater diversity of services and to increase fees.

However, as banks and other depository institutions expand their activities into other lines of commerce, the level of risk they are subject to may increase. Any increase in institutional risk is accompanied by an increase in the levels of risk for both the stockholders and clients of the institution to the extent they are not covered by deposit insurance. Ultimately, the level of risk facing the financial service industry as a whole would increase.

The general policy of deregulation suggests that financial institutions could compete on an equal basis if barriers between various types were dissolved. For example, thrift institutions were, for a time, severely threatened when they were stuck with low-yield portfolios when interest rates rose; they may be so threatened again. Federal policy has been to try to save troubled thrift institutions by allowing, encouraging, or arranging mergers. This includes mergers across State lines and mergers of mutual savings banks with commercial banks. More recently, Federal savings and loan associations have been allowed by the Garn-St Germain Act of 1982 to offer consumer loans of up to 20 percent of assets and to offer other consumer services so that their portfolios will contain assets and liabilities with better matched maturities.

On the other hand, thrift institutions in the past received some preferential treatment because they are the major source of loans for housing. An adequate supply of housing and a high rate of home ownership are widely accepted as social policy objectives, and a decline in the housing market has severe impacts on other sectors of the economy.

Policy Options for Issue 5

Option 1: Modify powers to offer financial services.

Congress could repeal Federal laws and regulations limiting the services that banks can offer and the activities in which they can engage. The U.S. Treasury has proposed that through holding company subsidiaries banks be allowed to engage in virtually all financial services. This is a movement toward deregulation, to “put all the players on a level playing field. ” It would be likely to increase the purchase of banks by other financial and nonfinancial institutions and to stimulate the buying up of small banks by bank holding companies. It would increase the possibility of banks exerting pressure on customers to buy nonbank services or products.

Congress could instead tighten the loopholes in laws and reaffirm the special and limited role of banks. Institutions that accept governmentally insured deposits could be permitted to offer only limited other services. Institutions that provide other services (either financial or nonfinancial) could be forbidden to own or control institutions that accept insured deposits.

A third possibility is to extend the barriers against banks diversifying their services by bringing all State banks (including those that are not Federal Reserve System members) under the Glass/Steagall Act through Federal preemption, so that States cannot use permissive laws to attract banks into relocation.

Finally, Congress could make modifications in laws and regulations to restrict (or allow) specific activities. It has been proposed for example that banks or bank holding companies be permitted to:

- underwrite mortgage-backed securities and offer mortgages so as to lower mortgage interest rates through increasing competition (as the Federal National Mortgage Association already does);
- offer mutual funds, in order to bring down management fees and sales commissions; and
- underwrite municipal revenue bonds, to supplement the effects of discount brokerage in increasing the market and lowering costs for municipal and State governments.

Option 2: Modify powers to effect mergers.

Congress could continue to allow other institutions to merge with or buy savings and loan (S&L) associations. If the acquiring firms use the savings and loan associations as sources of cash, the general effect will be a gradual reduction in money available for mortgages. Any company can now buy an S&L. Only if the company owns more than one S&L—and is therefore an S&L holding company-must it restrict its activities to housing finance, or even continue to offer housing finance. Nonfinancial institutions have already seized on the opportunity to buy S&Ls to gain access to some of the privileges and prerogatives of depository institutions, for example, federally insured accounts.

Congress can continue to allow mergers between thrift institutions, as the Federal Home Loan Bank Board is now doing. The likely outcome will be a smaller number of larger thrift institutions, but this may not solve the problem of attracting an adequate supply of funds.

Option 3: Provide incentives to support specific activities.

Congress could further provide capital assistance for thrift institutions. A Federal subsidy for thrift institutions could be justified on the grounds of the high social priority of housing, but it would add to Federal expenditures, increase the Federal deficit, and set a precedent when other financial institutions run into trouble. Congress could revise tax laws to encourage S&Ls to diversify their services further and to broaden their revenue base. It is not clear whether without this incentive the S&Ls will diversify enough to generate increased earnings.

Congress may want to provide incentives to stimulate other sources of mortgage money rather than attempting to turn back the clock on thrift institutions, which may not be operationally possible.

Issue 6: How will further deregulation of telecommunications affect the financial service industry?

An important consideration for future financial service policy will be the cost of telecommunications. As a result of the breakup of AT&T, Congress is now coming to grips with a broader issue of control of telecommunication costs; specifically, with the issues of access charges. It is expected that following the breakup, long-distance telephone rates will decline as a result of increased competition between suppliers, while local communication rates will tend to rise to compensate regional telephone companies for the loss of income from the Bell system. Congress is debating whether to levy a monthly access charge for all telephone use, which would tend to decrease the need for high overall local rates.

The distribution of function within the design of a system to deliver financial services is directly related to communication costs. Increased costs for local communications may discourage the use of third-party data processors, and small financial institutions may find it more difficult to enter the market or survive in the market. Financial institutions will attempt to move data processing toward the end-user in order to minimize the time a user must remain connected with a service provider's computer, i.e., encourage home banking. But consumers may reject this service entirely if either entry or maintenance costs are too high.

Comment on Issue 6.–The factors and relationships that must be considered in developing telecommunication policy are extremely complex and full consideration of them is beyond the scope of this assessment. However, Congress should be aware that telecommunication costs have a strong and direct influence on the economics of financial service delivery systems. Changes in telecommunication policy can result in the need to modify the structure of financial service delivery systems considerably.

Issue 7: What steps could be taken to realign the legal/regulatory structure to make it conform closely to the changing structure of the financial service industry?

Laws and regulations generally apply to specific categories of service providers. The operational differences between depository and nondepository institutions are progressively eroding, but these categories are still subject to different regulatory bodies. They have, in some cases, different interest rate ceilings, and they are subject to different restrictions on interstate operations and on intrastate branching. A financial institution, in fact, can sometimes select its regulatory climate by changing its organizational structure. S&L associations enjoy special tax incentives if a majority of their activities are housing loans. Accounts in depository institutions are federally insured, while other kinds of accounts are not. The buyer of services has different benefits, different risks, and different safeguards and rights, according to which service provider is selected. The consumer, however, is often unaware of the subtle and detailed differences.

Policy Options for Issue 7

The problem of how best to design, or revise, a regulatory structure for the financial service industry involves many subsidiary issues, such as Federal deregulation versus Federal preemption, institutional versus functional regulation, and self-regulation versus government regulation. The options considered below are not necessarily mutually exclusive:

Option 1: Design regulations to apply to functionally defined services and achieve specific policy objectives, without regard to the institutional provider of the services.

This option would put all financial institutions competing for a particular market niche on a more equal footing. It would mean, however, that each of an institution's services or functional activities would be considered separately. Yet the total mix of services offered would affect the behavior of the providing institution, the level of risk that it assumes, and its relative power in the marketplace. If various regulations were administered by different regulatory agencies, each financial institution might be subject to multiple regulatory agencies that may at times have overlapping or contradictory requirements and restrictions.

Option 2: Federally preempt all State legislation and regulation of financial services.

This option would provide consistency and reduce uncertainty for the industry with the possible result that financial service providers would become more active in developing and deploying services that the public would find attractive and useful. Yet the existing dual banking system has served well in meeting varying needs for financial services. Federal preemption would eliminate this duality and could reduce the degree of responsiveness of financial service providers in meeting local needs.

Option 3: Abolish all Federal regulations, allow*ing the States to control financial services fully.*

This alternative would allow each State the maximum opportunity to achieve local objectives and to meet local needs for financial services. It would also encourage many practical experiments and much innovation as States adopt alternative regulatory strategies. But States would also be prevented by the Commerce clause of the U.S. Constitution from barring entry by out-of-State banks. Nationwide financial service institutions would, how ever, suffer from the inconsistencies in restrictions and requirements.

Option 4: Combine all Federal regulatory functions pertaining to financial services under one Federal agency, mandated to develop an internally consistent system of regulations for all financial services.

On the one hand, this alternative would introduce a degree of consistency into the regulatory structure that is now lacking. Institutions would no longer be in a position where they seek charters from the agency that best suits their intended mode of operation. The increasing homogeneity of the market for financial services would be recognized in a unified regulatory structure.

Yet, the regulators serve the interests of spe cific constituencies that consist of both the institutions they oversee and their customers. If this diversity of perspective were eliminated, specific needs could go unmet.

Issue 8: Concerns of foreign governments regarding the protection of individual privacy could lead to the erection of barriers for American financial service firms doing business overseas. What steps could the United States take to address these concerns or circumvent the barriers?

Not only is the Nation continually moving toward a more highly integrated national economy, but it is increasingly knit into a global economy in which markets, trade patterns, fiscal and monetary policies, and currencies are linked across national boundaries.

Worldwide delivery of financial services has, for well over a century, depended on telecommunications and is now more than ever completely dependent on advanced technologies. Rapid and free movement of funds and related data internationally is essential. Financial institutions and other types of enterprises have branched across national boundaries and depend heavily on being able to move data freely, and confidentially, between plants and offices in several countries. The ability to access resources anywhere in the world from any other location has become an important factor in the operation of multinational corporations and in international trade.

Financial service organizations operate centralized systems that concentrate data processing for worldwide networks at one or a very few centralized points. Some, such as those that provide credit authorizations at point of sale, must be accessible from thousands of locations and must have a high degree of reliability. They move customer transaction data at high speed across all boundaries.

The ability to initiate a transaction from a remote location unfortunately also implies the ability to initiate fraudulent transactions; to monitor, interfere with, or extract data from a system from remote locations.

In a sudden hostile confrontation with another country, such as occurred with the Iranian hostage situation, the option of freezing the assets in the United States of the foreign power may be lost. Electronic execution of an order to transfer the assets from U.S. jurisdiction could be completed more quickly than a freeze order could be made effective. Foreign-owned banks might also, in some situations, provide to their governments or industries privileged information about U.S. industry.

Some nations have passed laws limiting the collection and dissemination of data associated with individual accounts across their borders, whether to safeguard the privacy of citizens, to protect trade positions, in the interest of national security, or for other reasons. Some nations are taking the position that they will not allow some kinds of data to be sent to nations that do not have restrictions on access and movement of data that are at least as stringent as their own.

Such restrictions could cause problems for U.S. firms because this country has not chosen to restrict the collection and dissemination of data in ways that would be seen to meet such requirements. To do so may place the United States in a position of establishing domestic policy in response to requirements arising abroad, a situation that may become more common as the global economy becomes more highly integrated and interactive.

A related concern is the possibility that international data-processing centers concentrated in a few countries are vulnerable to terrorist or military attack. As the reliable and orderly flow of international information becomes more critical to the U.S. economy, policy makers and national security planners must be aware of these vulnerabilities.

Worldwide information services may tend to increase global debt exposure and under some conditions could be destabilizing to world currency, commodity, and security markets. However, they could also be used to monitor and control international debts and repayments better and to overcome the destabilizing effects of a major debt default.

The national interest here is threefold: to stimulate and support the U.S. position in world markets, to further U.S. international diplomatic objectives, and to maintain national security.

Policy Options for Issue 8

Option 1: Establish no stronger protections for individual privacy' than already' exist.

The United States might test the proposition that the desire to have full financial relationships with institutions in the United States will be strong enough to overcome all other considerations. But the possibility exists that foreign governments with strong privacy protection laws may not be willing to allow the free flow of financial and payment data to and from the United States without specific protections instituted at a level commensurate with those provided their own citizens within their own borders. Any foreign bans that are instituted may focus only on electronic transmission of personal data to and from the United States, in which case the alternative of using nonelectronic media would still be available but could result in significant delays in the movement of funds and data.

At this point there is no compelling force motivating change. It does not appear to be an imminent probability that one or more nations will significantly restrict the movement of financial data to and from the United States. But this situation could change rapidly, and if this option is chosen Congress will want to continue monitoring developments in this area.

Option 2: Institute policies defining more precisely the conditions under which financial data can be collected and disseminated across national boundaries.

Under this option, U.S. privacy protection law would be harmonized with foreign laws to a greater extent, at least in the case of financial services data. Such policy might become necessary, should foreign privacy laws come to be applied to data transmitted and stored in computer systems on U.S. territory. Although Federal privacy law has not, in general, been applied to privately held data systems nor is there presently significant overt domestic pressure to extend it in that direction, precedent does exist in the particular case of banks for Federal laws concerning the handling of personal information.

Issue 9: What organizations could be granted access to the mechanisms for clearing checks, securities, and other payment instruments such as credit card drafts?

Only depository institutions now have direct access to the payments mechanism-clearing accounts with the Federal Reserve System, membership in local and regional clearinghouses, and membership in automated clearing house associations. Securities broker/dealers clear listed stocks and bonds through the organized exchanges, and market makers clear issues traded over the counter. Clearing mechanisms provide the means by which funds are transferred between and among accounts held by approximately 40,000 institutions in the United States. Without this means of conveying payment instructions between institutions and settling accounts, there would be no payment medium other than cash. Similar networks exist between the airlines for clearing among carriers that honor one another's tickets and between petroleum companies for settling crude oil accounts.

The essential elements of a clearing mechanism are the existence of an account through which net settlement can be accomplished and a means for transferring instructions that tell the account holder the amount to be transferred and the party to be credited. Banks have traditionally been the only ones able to establish settlement accounts and be party to the network for accomplishing the required information transfers.

In the present environment, nondepository financial institutions establish relationships with banks to obtain access to the payment mechanism. Drafts on accounts held by the nondepository institutions are cleared through the existing payment system and paid from a common account, normally maintained at zero balance, at a clearing bank. Only when the drafts are presented to the nondepository institution with whom the individual customer deals are the funds debited from the individual's account.

Banks and other organizations are not restricted in establishing arrangements for processing drafts similar to those in existence between operators of money market funds and banks.

For example, if the employees were agreeable, an employer could make an arrangement whereby employees are credited daily on the company's books with wages earned and are permitted to write drafts against those funds. The employer would then fund an account with a depository institution to cover drafts as they are presented and debit the accounts of individual employees for appropriate amounts. Regardless of the balance between benefits and drawbacks, such an arrangement would be operationally feasible.

The arrangements for clearing through a depository institution with access to the payment mechanism can be seen as being somewhat artificial. Given the technologies now available for moving and processing payment information, one could argue that others besides banks be given the option of establishing clearing accounts with institutions that offer them. A routing-transit number would have to be issued to any organization permitted such access to the clearing mechanism.

The question remains as to whether it is in the public interest to allow such arrangements. On the one hand, the existing regulatory structure provides assurances that parties to the clearing mechanism will be able to settle accounts as required. Opening the mechanism to unsupervised nondepository institutions not bound to existing requirements to meet settlement schedules could weaken the system and hence decrease the safety and soundness of the financial system as a whole. Under existing arrangements between banks and fund managers, the bank must settle with the payment system, even if the fund fails to meet its obligations. On the other hand, requirements could be established to ensure safety and soundness of the system that would have to be met by nondepository organizations that may be granted direct access to the payment mechanism.

Policy Options for Issue 9

Option 1: Retain restrictions on access to the payments mechanism.

Congress could choose to retain the present system whereby membership in clearing systems *is* limited to organizations meeting specific criteria. One could argue that the present mechanism works well and has been able to accommodate the changes that have taken place in the financial service industry. The safety and soundness of the industry have been well protected, and changes that create the possibility of weakening either should not be allowed.

On the other hand, there is a real possibility that innovative people will develop clearing systems that will operate outside of established channels. Off-market trading is a reality, and there is nothing to prevent the emergence of analogous systems for clearing payments. Nondepositor institutions have already gained access to the payment mechanism by acquiring banks and S&L associations. Electronic systems (especially packet switching) will lead to diverse channels for transmission and perhaps settlement, as will the requirement for explicit pricing of Federal Reserve services. Thus, as in so many other parts of the lega.1.regulatory structure governing the financial service industry, the present rules for access to the payments mechanism may be circumvented by applications of available technologies.

In the extreme, Congress could rule that all payments pass through the established payments mechanism. However, with the existence of private clearing arrangements between financial institutions and the multiplicity of systems for clearing payments, it would be extremely difficult to codify exactly what constitutes the established payments mechanism and the characteristics of clearing arrangements that would not be permitted under such a policy.

Option 2: Open the payments mechanism to other than depository institutions.

At the other extreme, Congress could open the payments mechanism to all who would join. As indicated, blanket access could weaken the safety and soundness of the financial service industry in that occasions where there would be failure to settle would become more likely.

As an interim step, the payments mechanism could be opened to nondepository organizations that would be willing to meet criteria designed to ensure continued integrity of the system. Such requirements could include provisions for maintaining reserves and provisions that members be audited to determine if they meet criteria for membership or that they obtain performance bonds or insurance that guarantees their ability to settle.

Yet, exclusivity of access to the payment mechanism by depository institutions balances some of the relative disadvantages of such an arrangement under the present legal/regulatory structure that limits the range of activities in which depository institutions can engage. The major sources of revenue of depository institutions in the future will be payments for services provided rather than the spread between the rates at which funds are obtained and those at which they are lent. Opening the payment mechanism to others could substantially affect revenues of depository institutions and, ultimately, because alternative sources of revenue are limited, their ability to remain viable competitors in the marketplace.

Issue 10: What alternatives for regulating interest rates are available to Congress?

In recent years, when market rates have exceeded Federal and State limits, significant quantities of funds have moved from banks, credit unions, and S&L associations to alternative investment opportunities created by new entrants to the financial service industry. These new entrants have relied heavily on advanced telecommunication and information processing technologies to implement their offerings. Constrained interest rates effectively limited the supply of funds to some investments.

Complete deregulation of interest rates would allow service offerings to respond to market forces, the price of services to be held down by competitive pressures, and interest rates to reflect national market conditions. However, to the extent that firms do not recognize the costs their actions impose on others, market forces may not reflect all social priorities. ' It may be in the public interest, under some circumstances, to modify or constrain the action of market forces on interest rates in order to preserve certain social objectives.

Interest rates, other than for corporate demand deposits, will be essentially decontrolled by 1986 as Regulation Q is phased out. It is possible that this situation could, under some conditions, result in the equivalent of price wars. Financial institutions have been known to raise interest rates to unsupportable levels in attempts to attract deposits. Widespread actions of this type could lead to an excessive number of financial institution failures, and as a result, could seriously destabilize the economy. Selective control of demand deposits and savings account interest rates is likely to cause funds to be drained from depository institutions. Usury laws restrict the supply of credit when interest rates are rising.

IControls on the rates paid on deposits by depository institutions, controlled under the Regulation Q system of ceilings, are being phased out under provisions of the Depository Institutions Deregulation and Monetary Control Act of 1980.

Policy Options for Issue 10

Option 1: Federally regulate all interest rates for all financial services and all institutions; preempt State usury laws.

Assuming the Government would set a national rate, this option would create uniform ity of interest rates across the Nation. Funds would not be moved from area to area in search of higher returns while they become virtually unavailable to those in need of credit in areas where rates have been capped at below market levels. Interest rate ceilings might be lifted to improve customer access to credit and to attract savings and investments; interest rates might be capped to reduce inflation or economic instability. They might be manipulated to preserve, for example, a housing differential.

On the other hand, the ability to set rates locally helps ensure their responsiveness of credit markets to local needs. This would be lost if the Federal Government were to preempt all regulation of interest rates.

There is no reason that a national rate be set. Rates could be set regionally or set in terms of ranges rather than at specific values. Such strategies could mitigate some of the disadvantages of this alternative, but the difficulty of implementing them operationally should not be underestimated.

Option 2: Completely deregulate interest rates.

In economic theory, at least, this option would allow funds to flow to highest value uses in terms of the costs and benefits included in the calculus. However, if indirect costs and benefits are not recognized, the resulting allocation of resources could be suboptimal. It would increase the availability of credit, but credit could be priced to levels that would effectively deny it to some consumers or cause them to change their way of life as they divert funds to cover its cost.

Option 3: Federally cap interest rates only for accounts covered by deposit insurance.

This option would cause money to be withdrawn from depository institutions when market interest rates rise, leaving more consumers exposed to risk because their assets would be in uninsured accounts.

Yet, some may view the reduced return as a cost of security and be willing to incur it. Limiting the return paid customers would reduce the pressure on institutions to make the more risky investments that provide higher yield, thus limiting the exposure of the insurance fund.

Option d: Allow States to regulate interest rates on all services delivered within the State, whether or not they are delivered by State-chartered institutions.

Under this option, States may try using controlled interest rates to attract businesses. Such tactics could significantly disturb the national money market. On the other hand, market forces complemented by the ease with which information can be rapidly distributed over wide areas would limit the options of the States. Individually, they would be able to selectively cut some rates within a relatively narrow range to support specific policies; but no one State would have the power to establish rates at levels substantially different from the norm. Experience has shown, for example, that States have not been able to artificially depress interest rates on loans made within their jurisdiction when significantly higher rates were permitted elsewhere.

Risk Allocation Issues

Issue 11: What are the alternatives for apportioning risk between financial institutions and their customers and clients?

The purposes of deposit insurance are: 1) to protect the funds of individuals, households, and small businesses against loss when financial institutions fail; and 2) to prevent the widespread economic instability that would result from cascading institutional failures as a result of a sudden loss of public confidence. Deposit insurance covers only traditional demand deposits and savings accounts in commercial banks and equivalent consumer accounts with S&L associations, savings banks, and credit unions.

At present, the Federal Deposit Insurance Corporation (FIDC) protects the depositor's principal up to $100,000. Securities Investor Protection Corp. insurance, on the other hand, guarantees the investor's shares, e.g., against broker's failure to deliver, but not the value of those shares. The "discount window" operated by the Federal Reserve System provides funds to banks that are temporarily unable to meet their reserve requirements and thus also functions as a kind of insurance for the very short term.

As a result of intermediation (consumers shifting their money to other kinds of accounts which give them a higher return), a large proportion of liquid assets and savings are not now covered by insurance. As banks diversify into other activities, they increase their risk of failure. The advantage of being covered by Federal insurance is one incentive for nondepositor institutions to buy banks and S&I, associations (increasing the tendency toward consolidation of financial resources).

Returns on investment recognize and reward acceptance of risk. Although deposit insurance provides an implied safety net for managers and stockholders of depository institutions, the price of increased efficiency is increased risk, if only because resources are tightly allocated, reserves are reduced, and margins for error are slimmer. The more efficient firms allow less room for error; and, therefore, the expected cost of a mistake increases. With a higher level of competition between financial institutions, the more efficient institutions will survive and some less efficient ones will fail. This is a benefit in economic terms, but because financial institutions play a critical role in modern society, their increased failure rate necessarily touches on the public interest in a way that risks assumed by other kinds of organizations do not. Such failures expose individuals, families, small businesses, and major corporations not covered by deposit insurance to risk of loss of capital or lifetime savings.

Two aspects of risk are involved here: operational risk (failure to settle, an implicit risk that is increased by the speed that new technology contributes to transactions and settlements) and institutional risk (institutional failure because of bad asset management). Operational failures, if they shake the confidence of customers, can greatly increase the risk of institutional failure. This was the problem that deposit insurance was designed to solve. However, deposit insurance itself may encourage firms to take excessive institutional risks by implicitly protecting them from the consequences of bad judgment.

Excessive risk assumed by financial institutions could affect the stability of the economy, if there is ever a series of cascading institutional failures in which each firm's collapse causes the collapse of others. At present, a combination of governmental actions to protect the deposit insurance fund (generally, allowing or arranging a merger between an endangered institution and another stronger one) and ad hoc cooperative actions by large financial institutions to shore up the market, nearly always prevents the spreading of undue detrimental consequences following any threatened or actual financial institution failure. But the speed at which funds are transferred and settlements are made today may make these resolutions much more difficult. Institutional financial crises could spread rapidly.

Many transactions will be timesensitive. If A fails to pay B, and B is therefore unable to pay C and D, these disruptive events will multiply with great speed. The increased number of daily or hourly transactions, the rapid turnover of assets, the smaller reserves held by an institution relative to the number and dollar value of transactions, and the complex interrelationships between financial institutions will contribute to the sensitivity of the financial system to short-term perturbations.

The result will be to increase the sensitivity of institutional equilibrium to even minor perturbations and to decrease the ability to control the secondary effects of disturbances.

Policy Options for Issue 11

Option 1: Retain Federal insurance, as it is now, for traditional depository institutions only.

Continuing the present program is consistent with policy that has provided adequate protection for the great majority of account holders and many holders of stock in financial institutions for over half a century. However, some argue that it gives managers of insured institutions a false sense of security and permits them to take risks they might not take in the absence of the insurance. Thus, insured institutions enjoy some competitive advantage over others in all lines of business in which they engage.

Option 2: Extend Federal insurance to certain ac*counts that are not held by institutions now eligible for insurance, but only to a specified low level per account or per customer.*

An extension of Federal insurance to all accounts that function either as transaction or saving accounts would eliminate a difference between suppliers of financial services that is important to many. Providers that are now insured would lose a factor that gives them something of a competitive advantage over those that cannot offer insured accounts. Vulnerability of the financial service industry arising from the exposure of depositors who have placed funds in uninsured accounts would be reduced.

Limiting the maximum amount of insurance would continue protection for the small depositor that has been provided historically. A larger proportion of the depositors would be exposed to loss. Possibly the propensity of the insuring agencies to find merger partners for distressed institutions would be reduced because the outlay of funds required if an institution were closed would be limited. Comparatively uninsured depositors would tend to exert pressure on financial institutions to avoid unjustified risks and to use sound judgment in making loans and in asset management. Large depositors might also be offered the option of buying insurance for deposits exceeding the limits of Federal insurance.

Option 3: Vary the insurance coverage and cost with risk.

This would permit insured institutions to position themselves in the market in a manner analogous to the way mutual funds characterize themselves. Some funds are growth-oriented while others seek stability and try to generate income for their investors. Depository institutions willing to take higher risks could purchase insurance at a premium price. Alternatively, depositors could elect to receive higher interest rates in return for dealing with an institution that provides only a reduced level of insurance coverage. In this environment, the depositor would have greater options than is now the case. However, the overall exposure of depositors to loss could increase if a significant proportion chose institutions offering lower levels of deposit insurance.

Issue 12: What is necessary to assure an adequate level of financial service to all segments of the population and to protect other basic consumer rights and interests?

In any case, people require some level of financial services in order to carry out their day-to-day activities and participate productively in the economy. They must at a minimum have a way of receiving and making payments, and generally some access to credit. Moreover, one can argue that they need mechanisms through which they can express preferences for specific services from among the alternatives that may be offered.

Because of the restructuring of the industry and its services, some traditional services may disappear, and others will be explicitly priced for the first time, or limited to certain categories of customers. For example, teller service may be limited to those with substantial balances, and merchants may be unwilling to accept or to cash checks. Market forces will tend to cause financial service institutions to encourage higher income customers, who are likely to have discretionary income to save or invest, and to discourage lower income customers with little discretionary income. Some low-profit services will probably be dropped.

Technology is making it possible for government agencies to operate more efficiently with regard to making payments. Direct deposit of all government payments is a long-range objective of the U.S. Department of the Treasury. This would include payments to State and local governments and contractors, and also entitlement payments and Federal employee paychecks. The move to direct deposit may conflict with the wishes of some recipients. Realistically, it is likely that some people will be pressured by government or other employers to accept payment by direct deposit even when they object to doing so.

Float is not a right or entitlement; rather, it is an attribute of a system that requires some period to process payment orders. It is clear, however, that many corporate cash managers, households, and many small businesses have in the past counted on float in managing their incomes. Because of information and communication technology, debits to accounts are in some situations virtually instantaneous, while crediting of deposits made by check must wait until the check is cleared. The customer sees this as an inequity, especially if he or she is charged for overdraft or automatic loan privileges during the lengthened gap. In fact, some financial institutions do abuse this situation. The technological capability to shorten the gap is available, but financial institutions need an economic incentive to apply it.

The right of consumers to full and understandable information about their rights, their risks, and their obligations in using new kinds of financial services may need explicit protection. Subtle legal distinctions between functionally similar services are not necessarily obvious to users, and information provided by financial institutions is not always clear, complete, or in comparable terms. Significant opportunity exists for misleading advertising of financial services.

Policy Options for Issue 12

Option 1: Define minimal services to be provided to consumers.

Congress could require all financial institutions, or those financial institutions choosing to offer certain services (e.g., accounts that function much like traditional demand deposit or savings accounts) to provide certain "lifeline" services, such as teller service or handling of direct deposit Federal payments, without cost to all of those desiring them. Alternatively, it could allow cost-based pricing. Congress could encourage institutions to establish an account that can only be debited electronically as a minimal service for some who misuse checking accounts but would like to benefit from such services as direct deposit. This might, for example, be a condition exacted in return for deposit insurance.

At the same time, Congress may wish to prohibit mandatory direct deposit of payments or to define legal rights to choice of payment mechanisms, at least in some situations.

Because financial information technology confers on the depository institution, which alone has access to the payments system, full control over the timing of debits and credits to accounts, Congress may wish to regulate the exercise of this power to assure that consumers are treated equitably.

Option 2: Define the rights of users to information regarding availability of financial service options.

New or revised legislation maybe necessary to define the rights of users to full and comparable information about financial service options and alternatives, and to establish a mechanism for implementing and enforcing these rights. An explicit policy of "informed consent" may be desirable. However, the costs of such regulations should also be considered.

Issue 13: Some changes in the delivery of financial services increase the possibility that the privacy of citizens could be eroded or violated. How can Congress reduce the possibility?

Citizens necessarily accept some diminution of privacy, or potential diminution of privacy, by engaging in any transaction other than exchange of currency. Nevertheless, some aspects of information technology greatly increase the opportunities for and the likelihood of invasion of privacy because data banks are aggregated, shared, and subject to unauthorized access, including access from remote locations.

The aggregation of financial data increases its commercial value, reduces the costs of accessing and using it, and thereby increases the incentive for misuse. Information technology also allows information to be propagated widely and rapidly, so that information harmful to the interests of a citizen (e.g., information about debt or payment behavior, whether this information is corrector incorrect) can affect that citizen's economic relationships in any location. The potential for loss of privacy is, however, not limited to financial or economic matters: to the extent that a citizen's transactions are effected through information technology, his/her location and daily activities and relationships become potentially subject to monitoring and recording. Information systems not related to financial services can involve similar risks.

It is the potential for this invasion of privacy, rather than evidence that it is occurring or has occurred, that concerns some citizens. It is likely that there is increased sharing of financial information and increased use of financial data for multiple purposes (e.g., mailing lists sorted according to information about the people on the lists). Furthermore, most citizens are probably unaware of the extent to which this occurs, of the extent to which law and business practice is able to assume the citizen's consent to this sharing of information as a condition of accepting a service, or of rights and protections associated with various financial services.

Policy Options for Issue 13

Option 1: Strengthen, expand, and explicitly define the citizen rights to privacy in accepting financial services (and conversely, rights to access and sharing of information by providers of financial and information services).

At present, insofar as a legal base exists for these rights, some of the protective legal provisions apply only to electronic media, and some apply only to paper-based services. Protection from intrusion only by the Federal Government is provided. But some financial services combine these modes, some are in transition between them, and some appear to have no explicit safeguards for the citizen.

While legally defined rights to privacy may be a desirable step in the direction of assuring privacy in using financial services, it may not be a sufficient step. Such legal safeguards should probably not depend for enforcement on victims' complaints. It is in the nature of information and its applications that citizens are unlikely to know when they have been the victims of invasions of their privacy until the damage has been done. Even then, they may be unable to trace unauthorized information or misinformation back to its source, to identify the offender, or to document that the abuse occurred.

Option z: Institute by law a program of informing citizens about risks to privacy that cannot be avoided in accepting financial services through information technology (a policy of informed consent, to use the model of medical services delivery).

This option at least has the advantage of allowing citizens to decide whether they will accept the risk and of challenging the industry to find ways of reducing those risks. However, it could have the undesired effect of decreasing public acceptance of and confidence in some financial services.

Option 3: Mandate a program of monitoring and enforcing privacy rights.

This option would require additional authority to inspect and monitor financial service institutions, and the allocation of resources for some Federal agency (e.g., the Federal Bureau of Investigation or the Department of the Treasury) to develop enhanced inspection capabilities as well as to implement the program. Furthermore, such an inspection program may increase anxieties about the possibility that the Government itself may violate the privacy of citizens through misuse of financial information about them.

Issue 14: Are additional actions needed to safeguard the integrity of the national payment and transaction systems against risk of disruptions from systems failure, hostile attack, and natural disasters?

Information technology and especially telecommunication links and networks create new vulnerabilities to accidental or deliberate disruptions, and also greatly expand the geographical extent of the impacts. With a highly integrated national economy and financial service industry and increased velocity of money, a local or regional disruption of financial activities rapidly propagates and can cause turmoil throughout the system, even if there is no irretrievable loss of data.

Natural disasters, civil disorders, military attack, or any form of emergency may destroy some communication links or require that others be taken over by emergency management teams. Thieves, saboteurs, political dissidents, terrorists, or others could attack information banks and communication links or threaten to do so, in effect holding hostage the assets of the public.

The direct effects of disruption of financial transactions and payments, of data banks, or of communication links are largely independent of whether the disruption is accidental or deliberate. The long-range effects of creating an attractive target for internal political violence or international terrorism are, however, worthy of special policy concern.

Little is known, at least publicly, about the present level of understanding of the magnitude of the vulnerabilities of financial service systems to systemic failure, external attack, and natural phenomena. Similarly, knowledge about the extent of preparation to deal with them, by either the private or public sectors is limited. Industry representatives have periodically stated that there are enough redundant network capabilities and backup data banks to handle any foreseeable contingencies. At a minimum, the Bank Protection Act could be broadened to cover all financial institutions. The act requires Federal regulatory agencies to establish minimum security standards for banks. The expertise of the Federal Emergency Management Agency (FEMA) could be brought to bear.

Whether or not the security measures taken by financial institutions at present are adequate is not clear, but the issue is clearly one that affects the public interest because the potential impacts of disruption are broad and critical to the national welfare. Actions taken to reduce these vulnerabilities run the risk of:

- negating some of the benefits of information technology; for example, requiring paper-based records, and creating redundant data bases and communication links, which could reduce the savings in time and/or add to the costs of services; and
- increasing opportunities for erosion of privacy.

Policy Options for Issue 14

Option 1: Hold hearings for further consideration of the present and long-term effects of dependence on information and communication technologies on the vunerability of critical economic and social systems and processes in the context of emergency management, civil defense, and national security.

Option 2: Create a national commission or an interagency task force to gather expert opinions from the financial service industry and from the various fields of emergency management, national security, civil liberties, and the like to assess these risks and recommend appropriate means of reducing or managing them.

Issue 15: What alternatives are available for controlling the risk of theft from or associated with financial service institutions?

Facts about theft (of funds or of information) associated with financial service institutions' use of information technology are obscure. Because public confidence is critical to this industry, it is not in the interests of financial service institutions to call attention to thefts, whether perpetrated within the industry or directed against the industry. Folklore and anecdotal evidence suggests that computer-based thefts are often not immediately discovered, often not solved, and often not prosecuted and that criminals are sometimes informally granted immunity from prosecution in return for revealing how they carried out the theft and for designing ways of preventing it from being done again. Some experts say that information technology has probably reduced the incidence of thefts of funds but greatly increased the average loss from a theft. Clearly, it has made the theft of financial data more attractive, since data are now aggregated into large, easily tapped data banks and since the theft of data need not involve actual removal of documents or other physical media from protected premises. Information technology has also:

- increased Federal responsibility for theft from financial institutions since it more often involves communication links;
- created the need for more sophisticated detection and documentation techniques; and
- transferred risk from institutions (the target of armed bank robbery) to individual customers (whose accounts may be fraudulently debited).

Policy Options for Issue 15

Option 1: Rely on the financial service industry and traditional law enforcement agencies to control crime.

Some believe that theft from financial institutions perpetrated with at least some involve ment of computers and telecommunication is increasing despite ongoing efforts of the industry and law enforcement authorities. Further, they do not see this rate of increase abating. If this is true, steps to augment present efforts are required; and even then, this option may not meet the challenge.

On the other hand, the level of consciousness of the problem among financial service providers is increasing. Greater attention is being given to security of advanced systems for delivering financial services. However, it is still too early to know if the efforts will prove adequate.

Option 2: Expand the resources and technological capabilities of Federal enforcement agencies (FBI, Treasury) to deal with computer-related theft and to train and assist local law enforcement agencies.

This option could increase the requirements for auditing and inspection of financial institutions' records. However, this may have the additional side effect of increasing concern over potential erosion of privacy and may also require additional audit trails and paper records, which add to the costs of providing financial services.

Option 3: Increase the penalties against perpetrators and against financial institutions for concealing or failing to report thefts or suspected thefts of funds or data.

Increased penalties for theft may deter some potential perpetrators. Increased penalties for failing to report theft will tend to bring to light data that clarify the magnitude of the problem and encourage the interchange of data needed to deal with it. On the other hand, if the data that surface cause the public to lose confidence in the financial service industry, the net effect could be negative and the stability of the industry threatened. Further, if the data show the success rate of thieves to be high or provide sufficient detail on the techniques that have been used, the end result could be an increase in crimes against financial service institutions.

Option 4: Mandate a national commission to study computer-related crime and identify necessary actions for its control.

Computer-based crime, which is by no means limited to that involving funds or financial services, is on the increase. A national commission to study all aspects of this modern problem would serve many policy needs.

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