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Financial Disintermediation in the 1990s

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Commentary:

Financial Disintermediation in the 1990s

By Alvin C. Harrell

Federal banking laws and policy continue to give rise to concerns about the future of the economy and the banking system. While the 1991 legislative proposals for banking law reform include several novel changes, they do not address other pressing matters relating to the excessive regulatory burdens and penalties imposed on the banking system over the past two years. Instead, by further increasing the powers of the regulatory agencies, and calling for regulatory seizure of still solvent banks, the proposals reinforce the pressures against healthy risk-taking by regulated financial institutions.

In the meantime even the most constructive elements of the 1991 proposals remain at risk as Congressional deliberations continue. At this writing, the competing interests that influence banking law and policy in this country have helped create a kind of policy gridlock that is preventing consideration of many potential banking and deposit insurance reforms. Of the limited reforms being considered, only those creating even greater regulatory burdens and enforcement powers seem assured of passage. All the while a self-induced credit crunch continues to strangle the American economy.

II. The Credit Crunch: Causes and Effects

While the seeds of this debacle were sown decades ago, the current problems began when the Bush Administration relieved the Congress of its responsibility for the deposit insurance mess by blaming crooks in the thrift industry for the insolvent of the FSLIC. Congress responded by imposing draconian new penalties and restrictions on banks and thrifts in FIRREA.

In the midst of the resulting credit crunch Congress (Continued on page 39)

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REB’s customers are not required to use MBC. HUD takes the position that this arrangement violates both sections 8(A) and 8(B) because REB is accepting and MBC is paying a referral fee pursuant to an agreement involving business incident to a real estate settlement service. The real estate settlement service involved is the making of a mortgage loan and the referral fee is that part of the fee which is based upon the number of mortgage loans referred. Section 8(B) is violated because REB’s agent and REB are receiving compensation beyond the reasonable value of the services rendered by REB. To the extent the thing of value is in excess of the reasonable value of services, the excess is not for services actually rendered and may be considered a kickback or referral fee.

9. _Joint Ventures_. In this arrangement, suppose MBC and REB (as defined in example no. 8 above), formed a joint venture to operate a financial center and each provides the same services described under the previous arrangement. The joint venture agreement additionally includes loan production goals and establishes a first right of refusal. HUD believes that this transaction also violates RESPA for the same reasons the transaction as described in Example no. 8. The fact that the arrangement is a joint venture is irrelevant.

10. _Controlled Business Arrangement_. Suppose MBC, a mortgage banker, purchases 50% of the stock of REB, a real estate broker. REB refers its clients to MBC for financing. MBC pays REB’s advertising expenses. Such expenses do not bear any relation to the quality or quantity of purchasers referred to MBC.

HUD takes the position that this controlled business arrangement is not prohibited by RESPA provided the three required elements are satisfied. First, REB must disclose to the client the existence of the arrangement. Second, REB may not require the use of MBC for financing. Finally, the only thing of value REB and MBC may receive from the arrangement other than payments otherwise permitted under RESPA is a return on the ownership interest. Because payment of REB’s advertising by MBC does not bear on the amount of mortgage business referred to MBC, it should not violate the third element.

11. _Computer Loan Origination_. Suppose a real estate brokerage firm pays an annual fee to access by computer a list of mortgage products offered by various lenders. At closing, the borrower pays a percentage fee which is divided between the realtor and the firm providing the loan information services. In the past, HUD has taken the position that this arrangement does not violate RESPA provided the good faith estimate states forth a disclosure of the fee to be paid the mortgage broker. Furthermore, the fee arrangement must be made between the borrower and the mortgage broker.

**D. Penalties**

Violations of Section 8 trigger both criminal and civil penalties. Section 8(d)(1) provides for criminal penalties in the amount of $10,000 and/or imprisonment for not more than one year. Section 8(d)(2) provides for a civil cause of action and an award of treble damages. Section 8(d)(5) provides for an award of attorneys’ fees and court costs to the prevailing party. With respect to controlled business arrangements, a person may not be held liable for failing to disclose the nature of the relationship if it is proven that the failure to disclose was not intentional and resulted from a bona fide error notwithstanding procedures that are reasonably adapted to avoid such error. Furthermore, only the person who is charged for the settlement service has a cause of action. Competing businesses or other persons who may be aggrieved by the arrangement do not have a cause of action.

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lender liability concerns, environmental law issues, bankruptcy developments, drug enforcement seizures of collateral, overly complex banking and consumer credit laws and regulation, and over-

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Finally, for the period from December 23, 1986, (the day section 1631 became effective) through January 8, 1987, the court ruled that subsection 1631(d) replaced the federal common law rule that would otherwise have applied to the FDIC. Under Section 1631, the FDIC, just like any other secured party, must give actual notice. As all farm products were produced in Nebraska, and the FDIC did not file EFSs as required, subsection 1631(d) immunized the auction house from tort liability for the sales that occurred after section 1631’s effective date.

FDIC v. Bowles Livestock Commission Company brings home the point that section 1631 impliedly repeals other federal law with which it conflicts. In the Bowles case, section 1631 implicitly repealed the federal common law relating to the tort of conversion and adversely affected the legal position of a federal agency. However, section 1631’s impact on other federal law will not always be limited to the legal rights of federal agencies. Other secured parties who claim protection under federal laws (such as the Bankruptcy Code) must now also take into account the implied-repeal impact of section 1631. Without providing full discussion, the authors next present two examples of the potential impact of section 1631 on the Bankruptcy Code.

First, a secured party has a perfected security interest in farm products produced in a PNS state but has not yet given PNS notice. While the farmer still owns the farm products collateral, the farmer files a Chapter 12 bankruptcy petition. Under the Bankruptcy Code, may the secured party give PNS notice to buyers, commission merchants, and selling agents without petitioning the court to lift the automatic stay against collection activities? Assuming the automatic stay would ordinarily prohibit the giving of such notice, does section 1631 implicitly repeal the automatic stay to allow the secured creditor to give PNS notice?

Second, a secured party has a perfected security interest in farm products under the UCC, but the secured party has not given actual notice to buyers, commission merchants, and selling agents as required by Section 1631. Does failure to comply with Section 1631 mean that the bankruptcy trustee cannot avoid the security interest under section 544 or section 545 of the Bankruptcy Code?

V. Conclusion

Numerous other section 1631 issues exist which are worthy of discussion, but space limits prevent their discussion. The report presented in this article hopefully provides a flavorful taste of the farm products issues after section 1631. Bon appetit!

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In the 1970s, this is largely a credit disintermediation. The banking system has been rendered less effective as a means of converting deposits into credit. Bank lending and borrowing transactions have been turned into a much riskier proposition than was the case just two years ago. In consequence, financial institutions are less willing to take lending risks and borrowers are less willing to take borrowing risks.

The result will continue to be fewer loans at higher relative interest rates, no matter what the Federal Reserve does. To an increased extent, bank deposits are going into Treasury Bills and other ultra-safe investments. As T-Bill interest rates reach low levels, investors may withdraw funds to speculate in the stock market or to invest overseas; the money supply indices may even rise as the banking system is flooded with liquidity, but bank lending likely will remain stagnant. For many loans that are granted, interest rates will be stubbornly high in relation to the cost of funds, as financial institutions struggle with the new legal and regulatory risks and higher deposit insurance premiums. Productive and creative investment will falter as entrepreneurs and many consumers find credit too expensive or even unavailable.

IV. The Impact of Merger Mania

The latest fashion in "quick and easy" solutions to the problems facing our financial system is the current fascination with giant bank mergers. This is founded on the assumption that there is "excess capacity" in the banking industry, a view suggesting that Hong Kong and Switzerland ought to be mired in economic distress due to the large numbers of their banking institutions.

Footnotes:

10 See Brief, supra note 7, at 4.
11 One interesting phenomenon already evident in the increasing evidence of deposit withdrawals is the increasing evidence of deposit withdrawals by many in the deposit market. For example, the deposits that have been withdrawn have been withdrawn by many, and the deposits that have been withdrawn have been withdrawn by many, and the deposits that have been withdrawn have been withdrawn by many.
12 This notion that "there are too many banks" is widely accepted, but yet seems questionable. While there may be too many deposits in each bank, it is not clear that there is too much bank insolvent, as evidenced by the stockpiling of potential taxpayer loans, that is the same as saving too many banks and too much competition. To shrink the entire financial system in order to control deposit insurance is old public policy, yet it is the net effect of the current emphasis on capital, mergers, and heavy-handed regulation. See, e.g., Bern, Capital Ratio: Too High for U.S. Banks, Am. Banker, Aug. 29, 1991, at 1. Fortunately, that Congress and the administration did not explore other ways to control deposit insurance failure by placing these pressures on the financial system.
While all businessmen (including lenders) love to see less competition in their industry, it is not clear that the larger society will benefit from a massive consolidation and reduced competition in the financial industry. Surviving institutions likely will benefit, as they will be able to charge relatively higher rates on loans, pay lower rates on deposits, and be more selective about who they loan money to. Profitability will improve, and financial institutions will be better able to afford the higher deposit insurance premiums needed to bail out the deposit insurance system. Perhaps that is what matters to policy makers today. But the credit crunch seems likely to continue, at great cost to our society.

This is an odd turn of events for a banking policy that not long ago was concerned about promoting deregulation and competition in the financial industry in order to generate economic growth and improve public access to financial services. Today such concerns are addressed only in the context of proposals to mandate certain financial services for the poor: "basic banking" accounts, required check cashing services, price controls on checking account fees, "truth in savings," etc. Whatever banking legislation passes in 1991, it is likely to include these features, along with greater powers for the financial regulatory agencies. While the trade-offs may be satisfactory to many financial institutions, and may succeed in preserving the deposit insurance fund, the results also seem likely to include a reduced economic role for our financial intermediaries in terms of funding consumption and innovation in the economy. In turn, this new "disintermediation" suggests serious society and economic implications for our society.

V. The Implications for Lenders

Congress and the popular media seem finally to have discovered fundamental problems in our financial system, although public understanding as to the causes and appropriate solutions is as elusive as ever. As just one example, attendees at the recent Annual Meeting of the American Bar Association in Atlanta, Georgia, heard congressional staffers and representatives of the FDIC explain that it is necessary that even greater regulatory and enforcement powers be included in the 1991 legislation, in order to assure the continuation of the deposit insurance system, apparently at any cost to private interests and fundamental principles of property and contract law. Lenders and their counsel are justly entitled to be concerned by this trend, and to be very risk-averse as a result. Yet, as attendees left one such meeting, they were greeted by a newspaper editorial blaming the recession on recalcitrant bankers for being too tough on borrowers. It seems never to occur to many commentators that the "tough" banking laws and regulations they so vigorously applaud have now come back to haunt the entire economy.

Then again, it is often surprising how little bankers themselves seem to understand about what is happening to them. Again to cite an example, at a recent luncheon sponsored by a local business organization, a banker was asked how FIRREA, the 1990 Crime Bill, and the proposed 1991 legislation will affect him and his bank. "Oh, not at all," he replied, confidently reporting that all of this was directed at crooks in the thrift industry and a few insolvent banks. It is hard to imagine anyone being so wrong about things that so directly affect him and his business. Perhaps it is all just too much for bankers (and the rest of us) to assimilate and understand.

Federal banking law and policy over the past two years reflect a legislative and regulatory system run amok, desperately seeking short-term solutions and scapegoats for 40 years of policy errors and mismanagement, and in the process trampling on private rights that have been considered fundamental to our society for over 200 years. The resulting trends are so ominous, and so fundamental, that it is difficult to fully comprehend the totality of the changes.

Nor is it clear exactly what forces are driving the changes. The understandable desire of the FDIC to enhance its power and to avoid a repetition of the FSLIC fiasco is only one factor; it has been joined by other influences that are not so readily apparent. One continuing mystery is why the Bush administration and normally responsible members of Congress have so eagerly embraced such ill-conceived legislation and policy, like FIRREA and the 1990 Crime Bill, that enhance parochial interests at the expense of the overall financial system and the economy. Speculation persists that the administration was "suckered" by certain members of Congress eager for a Republican political victory. While this seems far-fetched, recent federal banking law initiatives have been so blatantly counterproductive as to provide fuel for the most outrageous speculation.

VI. Prospects for the 1990s

Whatever the causes, the effects of current banking laws and policies will include continued financial disintermediation, as marginal consumers and entrepreneurial businesses are excluded from the credit system. The result likely will be a more stratified society. Blue chip corporations will be able to borrow at reasonable rates from large banks. Smaller but very credit-worthy business and consumer borrowers will have access to limited credit, but only at a relatively high cost. Finally, there will be a great mass of consumers and businesses with very poor prospects for participating in the regulated credit system. As in the past, all of this probably will be blamed on bankers and other lenders. In Congress, no doubt the preferred solution will be even more regulation, perhaps in the form of toughened equal credit opportunity and community reinvestment laws. There are, however, very few, outside of the Washington beltway, who sincerely believe that increased ECOA and CRA enforcement can substitute for an expansive, entrepreneurial financial system.

In effect, the marginal economic sectors of our society are gradually being excluded from the banking system, courtesy of federal banking laws and policy. It is a scenario familiar to other societies, and soon to be familiar to more Americans, as we experience the American financial disintermediation of the 1990s.

16. It seems likely that the adverse consequences will be felt the most in middle America, which depends in large measure on the financial services that are the linchpin of small businesses and consumers. In view of this, it is odd to see editorial writers in this area endorsing the trend toward fewer and larger banks. See, e.g., Front and Bigger Banks, Daily Okla., Aug. 15, 1991, at 12.
19. Demonstrators were seeking to have the examination be kept for use in a new bill to enact the Bush administration's [legal counsel]. "Senior White House, president of the Institute for Strategic Development, said: 'We know they would come back to haunt us.'"
20. The thing that is most depressing is that members of Congress know they are passing a deeply flawed piece of legislation, Mr. Show said. 'They knew it would come back to haunt them.'"