A Perspective on the Financial System

Alvin C. Harrell, Oklahoma City University School of Law
Commentary: A Perspective on the Financial System

By Alvin C. Harrel*

The depository financial system is caught in the midst of turmoil unprecedented since the 1930's. Highly regulated thrifts, restricted to making long-term fixed rate mortgage loans within a comfortable regulatory environment that also restricted their costs, were unable to cope when fiscal and monetary policy, inflation, and interest rates went wild in the late 1970's, leading to massive fund withdrawals and then higher costs of funds as interest rates were deregulated. Many of the current problems in the thrift industry have their roots in this period, as thrifts devastated by the 1970's used expanded powers to desperately embrace high-risk strategies in the 1980's in an effort to survive. Operational and geographic restrictions, inflation, and high interest rates also led many banks to rely on assumptions that real estate, energy, and commodities prices would continually escalate. The capital needs of foreign governments in developing countries and the ready availability of American credit also led to unmanageable financial burdens and increased prospects for default on foreign loans. The results of these events are dramatically changing the landscape of our financial system.

As Federal Home Loan Bank Board (FHLBB) Chairman M. Danny Wall points out in this issue, these problems need not be considered permanent. Although possibly sadder, today's banker should also be wiser. Banks and thrifts that can survive the inflation of the 1970's and the disinflation of the 1980's, and can learn from the mistakes of the past, should be able to minimize the effects of similar problems in the future. Legislators and banking regulators likewise should have a broadened perspective on the needs and risks of the financial industry. Hopefully these developments will lead to a better and more sound financial system in the years ahead.

This is not to say that the problems have all been solved. Challenges remain, and fundamental problems continue to plague the system. Among the concerns is the apparent inadequacy of the deposit insurance funds. No one can be sure just how long the public will continue to be satisfied with deposit insurance reserves that reportedly are inadequate to cover likely contingencies. Beyond such immediate concerns there are basic contradictions within the system that are not widely recognized. For example, there is an inherent contradiction in a system designed to allow depositors to reap the rewards of banking by making deposits in order to make profits, and the desire of regulators to eliminate these risks in order to protect depositors and the insurance funds. The current deposit insurance system is essentially a federalized version of the many private and state-sponsored deposit insurance systems that preceded it. Most of these systems ultimately failed, perhaps partly as a result of the contradictions inherent in an effort to make a fundamentally risky business (banking) free of risk for certain of its investors (bank depositors). It remains to be seen whether the current system can manage this basic contradiction in workable fashion.

In the postwar period the preferred solution was to strictly regulate the lending and investment powers of financial institutions. As a result, for example, thrifts were essentially limited to making long-term fixed rate mortgage loans, in order to limit their portfolio risk. The disastrous consequence of this, when the inflation and high interest rates of the 1970's sharpened the dichotomy between lending long and borrowing short, is now apparent to all. For awhile, during the postwar period, it appeared that this system of tight regulation could restrain risk and manage the inherent conflict between that restraint and the need for profits. It is now clear that this safety net worked in the postwar period only because it wasn't widely needed. Postwar circumstances that provided an environment of stable prices and interest rates, nearly uninterrupted prosperity, and world dominance by U.S. corporations facing no significant foreign competition, limited banking failures to isolated incidents.

Such an environment does not test the system; the harsh realities of the 1970's and 1980's, in contrast, tested virtually every segment of the U.S. economy, including banking and finance. The bank regulatory system was tested and, like virtually all deposit insurance systems before it, was found wanting. String regulation did not prevent mismanagement, losses, or failures. It has not provided a self-supporting system of deposit insurance adequate to cover a realistic estimate of probable losses.

The new FHLBB system of risk-based capital requirements, described by Dr. Donald J. Bisenius in this issue, represents an effort to address the conflicting needs of risk and safety, without constraining the operational flexibility of the industry. If this approach succeeds, it may become one of the most significant achievements in the history of banking regulation. Reconciling the twin requirements of risk and safety is a challenge that must be met if a private and prosperous depository banking system is to continue to exist into the twenty-first century.

Other fundamental contradictions also are cause for concern. The concept of an independent supervisory authority, expertly regulating in detail the operations of an entire system of financial institutions, may be conceivable in the abstract. It remains to be demonstrated, however, whether representatives of the regulatory agencies can be consistent in their use of superior judgment and expertise as to individual business decisions. If not, there will continue to be a risk that regulatory misjudgments may com-

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1. The views expressed in this commentary are those of the author and do not necessarily represent the position of the Conference on Consumer Finance Law or the Quarterly Report. Opposing views are sought.


QUARTERLY REPORT

approval can be accomplished automatically at the point of sale. In many
machines take cards, many manual sales tasks can be automated.

Looking ahead, Telexa says that in the credits cards industry, the
PCA from 1974 to 1979, which was authorized in 1981 to 1983 to estimate
function for bank card plans. The measurement of output was the ratio of active ac-
counts to sales slips. As output increased, a firm moved toward increasing returns to
capital. The implication of the evidence of scale in bank card plans is that
the important role of bank cards and accounts for sales slip processing shortcomings
issuers attempt to move down the cost curves. And, we would see to come more
close to realizing increases in the level of service and market

Finally, the authors investigated the value of credit cards as issuers used them
to cross-sell deposit accounts, consumer
loans, and insurance. They found
that demand deposits and time deposits were good
vehicles for cross-selling bank cards but that bank cards were not necessarily a
good tool for increasing the number of
demand deposits and time deposit accounts.
A. Charles Sullivan

Thomas F. Morrissey, "Debt Management by Households: The Evidence in Loan
Programming (1987), pp. 49-61. (For information on the country of
Banking and Finance, Federal Reserve Bank of Chicago, P.O. Box
Chicago, IL 60606.)

Questions related to the determinants of the optimal financial structure for
households have resulted in studies of debt management
practices of households. This article analyzes the way households allocate
their debt among different types of debt, and the

High expected inflation rates provided
households with an incentive to reduce loan
repayment rates. The expected inflation rate was higher than the expected
inflation rate, i.e., the after-tax cost of debt increased. This relationship is true
for all types of consumer installment credit cards.

The article concludes that the results of his study were useful for understanding
household debt management behavior. He found that the relationships revealed by the
analyses were not all consistent over time. But a high percentage of the variance in
repayment rates can be explained by the

A. Charles Sullivan
QUARTERLY REPORT

Introduction to the Issue

Among the major non-judicial consumer and commercial law developments of the past year, three stand out: (1) The Consumer Credit Protection Act of 1987 ("CEPA") and in particular the Expedited Funds Availability Act and Regulation CC; (2) The new U.C.C. Article 2A-Leases; and (3) The UN Convention on Contracts for the International Sale of Goods. The first of these developments, the Expedited Funds Availability Act, which partially federates the U.C.C. Article 4 payment system, was described in the last issue of the Quarterly Report by Professor Fred H. Miller. In the opinion of the Quarterly Reporter Robert C. Chaffin, provides an update and perspective on another, earlier effort to federally preempt Article 3 of the U.C.C.—the FTC holder in due course regulation. The second major development of the past year, new U.C.C. Article 2A, is described in this issue by another article by Professor Millen; the UN Convention will be described by Professor Peter Winkin in a subsequent issue of the Quarterly Report.

This issue also contains articles by Emily E. Haddad, Daniel G. Daniel analyzing important consumer credit cases in three areas that affect the rights and liabilities of guarantors and sellers. These articles are followed by the first of a series of Articles on contract law, and an article authored by William E. Carroll and your editor that highlights an area of conflict between Article 9 and the Public Act. Article 1 of Article 2A, an article on acquisitions of rights of power and other industrial companies, originally scheduled for this issue, has been delayed and will appear in a subsequent issue.

Also in this issue is a report on the 1988 Annual Conference, which was held in Honolulu, Hawaii. For those of you who did not attend this event, it was a highlight of the ABA Annual Meeting. Each year our own conference is limited to about 2,500 persons who are distinguished judges in a test of advocacy and legal analysis. The cases presented are designed to test the limits of emerging legal issues in the context of consumer credit law.

All of the Annual Argument presentations in conjunction with the ABA Conference members are not required to register with the ABA to attend. Plan now to attend the 1989 Annual Argument, to be held in Honolulu, Hawaii, during the April 5-8, 1989 ABA Annual Meeting.

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Summer 1988

The Quarterly Report is published twice a year. Please address all correspondence concerning this Report to the ABA's General Counsel, 750 North Lake Shore Drive, Chicago, Illinois 60611.

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Holding In-Due-Course and the F.T.C. Rule:
From Consumer Beware to Caveat Emptor a La Lender

By Robert C. Chaffin

The Doctrine makes perfect sense in its disregard when the interests of the borrower and the bank or the lessor, dealer, and surety are equal. It is as relevant to the law of contracts as to the law of debts, and it is as relevant to the law of sales as to the law of bailments. It is as relevant to the law of partnerships as to the law of corporations. It is as relevant to the law of corporations as to the law of partnerships. It is as relevant to the law of sales as to the law of bailments. It is as relevant to the law of contracts as to the law of debts, and it is as relevant to the law of debts as to the law of contracts.

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