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The Great American BANKING SNAFU

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Preface

This book is the product of curiosity: first, as to why the U.S. banking system is so racked by crisis and instability and its payment system is so backward, and, second, as to whether the United States could benefit from the experiences of Sweden, whose stable system is recognized as one of the world's most technologically advanced. Because banking historically has been the most regulated of all industries, government policies can mean the difference between success and failure for financial institutions. But anything involving money and politics is inextricably bound up with the whole gamut of human strengths and frailties, with some plans that succeed and more that go awry, and with people's universal fears about security, privacy, and crime. Hence, the answers to the questions were to be found in social and political, as well as economic and technological, forces.

In addition to studying all the pertinent material available in the United States, I learned the Swedish language in order to overcome the problem of penetrating what one scholar has described as "the largely self-congratulatory views typically offered by Swedes for foreign consumption."[1] Then I spent seven months in Stockholm, conducting interviews and poring through hundreds of books and documents.

A historical orientation is taken because, rather than treat policy as a choice made at some time X, isolated from social and structural context, the book shows policies resulting from an accumulation of past events, political and organizational constraints, and values with roots reaching back into time. Five separate but overlapping areas of significance to the industry—structure, competition, technological cooperation, consumer protection, and employment—are examined, with sufficient behavioral detail provided to permit some conclusions about the reasons for the policies adopted and their effectiveness.

Chapter 1 outlines the development of the banking and payment systems in the two nations and the political, cultural, and economic environments in which they evolved. It reveals the role of the Swedish and U.S. governments

in running and regulating banks and the public attitudes and values that led to the emergence of that not-so-silent partner of all bankers, the government.

In chapter 2 the major payment mechanisms in both nations are described to facilitate understanding of the remainder of the book, which focuses not so much on what payments systems nations have as why they have them. The role of crime in Sweden's early adoption of cashless payment mechanisms is related, along with the story behind the giro, which in Europe is called ''the poor man's bank."

Structural issues are examined in chapter 3, including the populist politics behind the thorny branching and interstate banking problems in the United States, which prompted banking by loophole and culminated in the anomalous "nonbank banks" of the 1980s. The background to the invasion of the "money snatchers" is described, as well as the mayhem resulting from the lopsided 1980 deregulation legislation. By contrast, the development of Sweden's stable structure is depicted, along with its all-in-one agency and more cooperative approach to supervision of the industry.

Chapter 4 covers competitive issues, with an explanation of how forty years of oppressive U.S. regulation stifled innovation and competition in the industry. Both Swedish and U.S. cartels are described, plus the mass money migration in the United States when the government-imposed cartel was cracked by securities firms followed by retailers, placing U.S. financial institutions in the unique position of having to compete with unregulated companies. The secret to the success of small Swedish savings and cooperative banks in competing with large ones is revealed, as well as how the Federal Reserve competes with some U.S. banks.

Technological cooperation is identified as a key to Sweden's lead in electronic funds transfer systems (EFTS) in chapter 5, which tells how the Swedes came up with a futuristic national EFTS plan in 1972, including home banking. However, while in recent years the Swedish bankers have become less cooperative and more independent as a result of self-confidence about EFTS, the Americans have just entered the stage of cooperation. Surprisingly, the chapter shows how the Americans relied on their government to take the lead in developing EFTS, while the more socialistic Swedes did it on their own.

An expert on privacy law has said, "Although the United States is the most advanced nation in the world in the field of computer science, we must look elsewhere to find comprehensive legislative proposals for solving the computer-privacy problem."[2] In chapter 6, Sweden's creation of the world's first national computer privacy law and its successful implementation are described, along with consumer protection in general, security, the massive wave of credit card fraud, and the effects of electronic banking on employment.

The final chapter summarizes and analyzes the material present earlier to explain how Sweden's system dynamically progressed to excellence while

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that of the United States lagged behind, with the problems that set back the United States spoofed in "The Team That Couldn't Win." It is followed by evidence that the United States has never had a sound banking system, with the crisis of the 1980s but one of a long series of crises over the years. Thus, it is argued that since Congress over the course of more than a hundred years has failed to secure a sound system for the nation, it is time for the public to take the lead in demanding reforms to achieve one. To deal with some of the major problems besetting the industlry and disturbing the American public, a series of pragmatic, if perhaps controversial, proposals are presented. If they stimulate debate that leads to corrective measures, this book will have served its purpose.

Notes

1. Thomas J. Anton, *Governing Greater Stockholm: A Study of Policy Development and System Change* (Berkeley: University of California Press, 1975), p. 135.
2. Arthur R. Miller, *The Assault on Privacy* (Ann Arbor: University of Michigan Press, 1971), p. 227.

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1
Building Blocks of the Past

> For a part of the time, we rested in the imaginary security of ignorance; for another part, we seemed indifferent to our plight; and for the remainder of the time we were afraid to apply the remedy lest we interfere with the processes and profits of a privileged class.[1]
>
> Honorable Carter Glass

Written some sixty years ago to describe the government's reaction to the instability of the banking system in the years preceding passage of the Federal Reserve Act, the words above just as aptly depict the background to the upheaval of the U.S. banking industry in the 1980s as nondepository institutions captured a major share of the nation's financial services and congressional gridlock precluded legislative remedy. The blanket of protection the government laid on the industry when it banned the payment of interest on checking accounts and set interest rates on deposits below market rates provided only "imaginary security." Moreover, the blanket smothered the industry by stifling competition and innovation so that while in other countries banking was transformed to an electronic information system, U.S. banking remained mired in an anachronistic check-based payment system.

There was "ignorance" of the fact that technological advances had made it possible for any firm with computer capability and a few phone lines to get into payment services. And they did. By the end of 1984, economic guerrillas had funneled $214 billion into 332 money market funds, and only $297 billion remained in savings accounts in the banks and thrifts. By the time regulators overcame their "indifference" and authorized competitive products for the industry, it was too late: the public had found not only higher rates of return for deposits but also an alternative to standing in line and sullen service. That demolished another source of "imaginary security": the carefully nurtured myth that, given the choice, the public would always choose the safety of insured funds.

The "remedy" Congress applied to the hemorrhaging industry in 1980 with deregulatory legislation ignored the reality that its structure had already been shattered into only two segments: the regulated and the unregulated. Trying to preserve the old compartmentalized structure was about as mean-

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ingful as rearranging deck chairs on the *Titanic* after it hit the iceberg. The legislation was, moreover, little more than a Band-Aid, since it deregulated only the deposit side of the banks' operations; it increased their funding costs without enabling them to diversify their product lines. To cover the higher cost of purchased funds, the regulated firms sought higher yields by investing in riskier ventures. With the premiums for deposit insurance unrelated to the riskiness of assets, the financial institutions gambled on being bailed out if they got into trouble. And they did. In 1983 there were ninety-five failures and arranged mergers of savings and loans (S&Ls), and when in 1984 the nation's largest S&L suffered a liquidity crisis, the Federal Savings and Loan Insurance Corporation (FSLIC) could not rescue it because the agency's $6.3 billion of insurance funds could not cover the thrift's $12 billion of insured deposits. More banks failed in 1984 than in any year since the Great Depression, and the government virtually nationalized Continental Illinois to avert its collapse. Not surprisingly, public confidence in the banking system declined, thereby jeopardizing the regulated firms' one competitive advantage: trustworthiness.

With an unblemished trustworthy image, a card base larger than Visa's, and 813 stores linked by a powerful computer system, Sears, Roebuck by then had expanded into financial services, along with J.C. Penney, American Express, stockbrokerages, and insurance companies. Those firms were to banking what the Japanese interlopers had been to the U.S. auto industry, and Continental was the Chrysler of the banking industry. Like the Japanese automakers, they had lower costs: they used computerized products, were not hampered by interstate and branching restrictions, and were not burdened with noninterest-bearing reserves, low-interest mortgages, or nonperforming loans. Like the U.S. automakers, the bankers sought protection from the predators. But at the same time, they sought permission to expand into the insurance and securities fields, which prompted those industries to demand protection. In the ensuing melee, regulators clashed with one another and with Congress, which lapsed into paralysis, afraid to anger any of the special interest groups that constitute the "privileged class" of the 1980s.

As a harsh reminder of what this chaos was costing the public, an international survey of retail banking castigated the U.S. payment system as "very backward" and "one of the least efficient" in the developed world, while Sweden's was rated the most efficient.[2] Indeed, while in 1984 U.S. banks advertised "the beginning of electronic trade payments and the end of checks," those payments in Sweden have been made without checks since 1925 and electronically since 1964. The Swedes have had direct deposit of pay since the late 1950s and have had two nationwide networks of cash dispensers since the 1970s. No depositor there has lost a cent since 1929, and since the industry was deregulated in 1968, savings and cooperative banks have offered the same services as the commercial banks. Moreover, while the cost of

federal banking regulation alone in the United States increased 48 percent between 1980, when deregulation began, and 1984, one Swedish agency with sixty people supervises over 570 banks at no cost to taxpayers.[3]

How could a nation the size of California but with only 8.3 million people have the top-rated retail banking and payment system in the world? Just as Japanese management styles have been studied in efforts to learn the secrets of that nation's success in manufacturing, this book comparatively examines the evolution of the banking and payment systems in Sweden and the United States to see what lessons about financial services can be learned. Because such systems reflect the economic, social, and political conditions that have prevailed throughout a nation's history, the study begins with a review of the foundations on which the two systems have been built. In the process, striking patterns of commonality, as well as differences, emerge.

Sweden's Extraordinary Early Monetary History

In retrospect, it makes sense that the country that was the laughingstock of Europe in the seventeenth century because it had the heaviest coins in recorded history should be a world leader in weightless electronic funds transfer systems in the twentieth century. It took a while, but the Swedes finally got the last laugh.

It all began back in the days when Sweden had a monopoly on copper, in which the government had a vested interest as part owner of the largest mine. Hence, in an effort to maximize his return on investment, the king in 1624 replaced the silver standard with a bimetallic standard based on silver and copper. Since Gresham's Law had not yet been translated into Swedish, the king was surprised when the copper coins drove the silver ones out of circulation and dismayed when the resulting overissue of new coins depressed copper prices.[4] Although it was conceded that the scheme had been based on a miscalculation, the standard survived until 1776.

Meanwhile, there were those coins. Since the price of copper was barely ¹⁄₁₀₀th that of silver, the ten dollar coin was a record-breaking 43 pounds. The most common coin, the two dollar piece, measured about 9.5 inches diagonally and weighed over 8 pounds. People had to use horse carts to haul the large, rectangular slabs when making major payments. Although foreigners found the sight of the natives staggering about under the weight of the coins on their heads and backs a real sideshow, the stolid Swedes never saw the humor in the situation. A Swedish historian has characterized as "rather malicious" the comments of a Danish diplomat who in 1720 wrote home: "Four riksdalers (dollars) would be a terrible punishment for me if I had to carry them a hundred steps; may none here become a thief."[5] One unintended consequence of the large coins was their stimulus to the development of Sweden's

transportation infrastructure. Roads had to be built so that treasury agents could use the wagons necessary for hauling in the cumbersome tax collections from the countryside.

Actually Swedish coins can be traced back to the Viking age, although a barter economy prevailed then. Fortunately, they were not made of copper, or their ships probably never would have made it out of the harbor, thereby denying history those adventuresome sagas. The earliest recorded comments on Swedish monetary policy can be found in the Stockholm chronicle of 1592–1593, in which the city clerk noted that too many bad coins had been struck during the preceding year, and "contempt of money swiftly rose . . . so lately nobody has wanted to sell his goods for the bad and soft money."[6] Thus, the nation returned to a barter economy, which endured there for centuries longer than in other European countries. Certainly the cumbrous copper coins did little to enhance the concept of money, but they had another unintended consequence that did: the introduction of Europe's first paper money in 1661.

In 1656 a Livonian named Johan Palmstruch obtained a charter to establish a bank in Stockholm, although he had been imprisoned in the Netherlands for economic espionage before coming to Sweden. His innovative, if ultimately fatal, idea was to issue bank notes as receipts for deposits of the bulky copper coins. Within a year this inspired another innovation—in crime: the world's first forged bank note.[7] However, the weary-armed Swedes embraced the paper money with no less enthusiasm than did the banker, who was enjoying interest-free deposits. Palmstruch, then, in the words of a historian, "lost both common sense and decency": he issued more notes than could be redeemed in hard cash.[8] When word spread that the notes had been depreciated, it caused a run on the bank. To quell the panic, the government closed the bank, sentenced Palmstruch to death, and banned foreigners from bank ownership, a law still in effect in 1984. The first paper monetary system failed with a crash and produced a distrust of bank notes that persisted for almost a century. Everyone agreed, however, that the bank had been useful, so Parliament took it over. Thus, the Riksbank, the oldest existing central bank in the world, was established in 1668.

At the end of the seventeenth century, the king's financial adviser launched yet another innovation: light copper dollars adapted for the pocket. But they were easily counterfeited and were, moreover, issued without limitation so that they depreciated wildly. Since the Swedes take monetary matters seriously, the adviser was beheaded in 1719 for "ruining public credit by imaginary money" and for having given the king bad advice.[9] That put a damper on innovation in the monetary area for a century or so.

During a money crisis in 1773, a discount company was chartered, an event that marked the beginning of commercial banking history in Sweden. The firm was so successful that the king could not resist the lure of its profits. Although its charter had not yet expired, the state acquired it, thereby cre-

ating its first commercial bank. Three private discount companies were also founded, and they prospered until the crisis at the end of the Napoleonic wars when the government had to step in to help them. Although the rescue effort succeeded, discount firms were never the same again. By this time, the national affliction commonly known as "Royal Swedish Envy" had given rise to criticism of the firms' high profits, which had provided dividends of 24 to 28 percent even during the worst years. To make bad matters worse, auditors discovered that one company had made sizable illegal loans to the city's biggest businessman. When news of the scandal got out, there was a run on all discount houses, and the state shuttered them. After the fall of the discount houses, which are regarded as Europe's first commercial banks outside Great Britain, Sweden lacked full banking activity for a long time.

The average Swede then could not have cared less. The burning problem was not capital acquisition but widespread poverty. This was a country that in 1632 had hesitated to invite foreign dignitaries to the funeral of its fallen king for fear that "they will see how poor we are."[10] During the eighteenth century, untold thousands of Swedes died of starvation, and the so-called last great starvation was not to occur until 1868.

The poverty may seem perplexing, since at the time Palmstruch founded his bank Sweden was regarded as a first-rate military and political power; however, its power has been described as a "colossus on feet of clay."[11] Although the copper industry provided financing for the wars that raged from 1600 to 1720, during the next hundred years wars were paid for with paper money. It resulted in heavy financial obligations, which led Europeans to refer to the country as "the fortified poorhouse."[12]

The country's social problems came to a head when humiliating defeats in the war with Russia in 1808–1809, during which Sweden lost all the land it had won in earlier wars, led to the deposition of the king and a demand for a new form of government. The result was the Constitution of 1809, which, after the U.S. one, is the oldest written constitution in the world. Yet while philosophers hailed it as the freest constitution in Europe, the Swedish masses did not receive the right of political participation until the end of the nineteenth century. Although the peasants constituted a majority, the bulk of the country's wealth was concentrated in the hands of a small number of families. Hence, as Sweden emerged from its last long century of warfare, the uneven distribution of economic and political power caused an undercurrent of disquietude.

Beginning of the U.S. Monetary System

In search of a better life, a boatload of Swedes emigrated to the United States in 1638 and founded New Sweden, near what is now Wilmington on the Delaware River. Like other early settlers, they used barter for trade as they

had in the old country. Later, as commerce developed, the colonists used coins of other nations, which they acquired through trading. Although the British forbade the coining of an American currency, when a serious shortage of money disrupted business activity in 1652, British colonists in Massachusetts built a mint to turn out silver shillings and operated it until the British closed it in 1688.

Although checks did not become popular in England until the end of the eighteenth century, they were introduced into the American colonies with an experiment that began in 1681. Called "The Fund at Boston in New England," the scheme was developed by a group of Boston businessmen to compensate for another shortage of hard currency. They mortgaged their land and commodities to the fund in return for credit against which they could draw checks. The checks were soon replaced by paper currency, however, which was better suited to the needs of the time.

The development of paper currency in America, as in Sweden, followed that of coins, albeit not initially as a solution to a weighty problem. Like the later issue of notes in Sweden, however, the colonial paper money was created more in response to the needs of the war than those of business. The first American paper money was printed to finance the 1690 expedition against the French from Massachusetts.[13] One promoter of paper currency was Benjamin Franklin, who published "A Modest Enquiry into the Nature and Necessity of a Paper-Currency" in 1729. His argument in the book was so compelling that it won him the job of printing some money, which he embellished with a pattern of leaves. Since the art of counterfeiting had reached the New World by then, the pattern was intended to discourage practitioners of the trade that had been invented in Sweden. Another deterrent was Franklin's imprinted warning, "To Counterfeit is DEATH."[14]

Inasmuch as the Bank of England had been established in 1694 and the British banking system had developed considerably in the intervening years, that system was proposed as the ideal pattern for every colony to emulate. But a vastly different system developed in America. Rather than found a few large banks, which then could serve the country through a widespread network of branches, the United States developed a system made up of a great many individual banks, with branching rigidly controlled. To a large extent, the U.S. system can be viewed as a reflection of two value orientations so strongly ingrained in the culture that to some Europeans they appear to be phobias: a fear of big business and a suspicion of banks.

In order to provide funds for the beleaguered Continental Army, a group of patriotic merchants formed the Pennsylvania Bank in 1780. Congress pledged to protect its subscribers against losses, even though it was a private firm. But it operated only until late in 1781, when the United States' first real bank, the Bank of North America, was chartered. The bank's equity capital included loans and gifts that the ubiquitous Benjamin Franklin obtained from

the French treasury. Reminiscent of Sweden's early experience with coins, it took sixteen teams of oxen two months to haul the funds from the port of Boston to Philadelphia. The bank made loans, took deposits, and issued paper currency, which circulated in the East. In the wooded mountains of eastern Tennessee, however, where the State of Franklin existed from 1784 to 1788, the backwoodsmen used animal furs as official coinage, with the governor paid in deerskins and assembly members reimbursed in raccoon skins.

The evolution of the U.S. banking system, like that of Sweden, differed from those of many European countries in that banks of issue were founded without the nation's first developing a private banking system. In this regard, it was based more on the model of the Bank of England than on the British private banking system. The reason was that the young nation needed money, and since banks create money, it needed banks. At the same time, however, there was strong political opposition to banking. Hence, banking was treated as a quasi-state monopoly, with legislatures giving rights to banks based on the notion that they were responsible to government. Therefore, banks in America, as in Sweden, have never enjoyed true laissez-faire; the government has always been a dominant figure in the industry.

Prior to 1828 the approval of Congress or a state legislature was needed for a charter, and regular reports to public officials were required almost from the beginning. By 1800, however, chartered banks were complaining about the same issue that bedevils them in the 1980s: unfair competition from unregulated competitors. By then, schools, canal companies, and other businesses had learned that they could go into debt profitably by issuing notes that looked like money and circulated like money. In response, New York State, among others, passed restraining legislation to ensure its six chartered banks a monopoly on their rights. The law made it illegal to conduct banking activities without legal authorization and provided a bounty of $500 for the conviction of unauthorized bankers.

Growth of the U.S. Banking System

Although Secretary of the Treasury Alexander Hamilton was fully aware of the deep distrust of banks and "moneyed interests" by many Americans, in 1790 he presented a plan for a national bank. To assuage the fears of those who envisioned a European-type central bank, he proposed that it would not have a large number of branches and would be under private rather than public control. Hamilton wanted the bank because it could provide financial services to the federal government; its note-issuing powers could convert the national debt into a useful medium of exchange; and it could provide additional short-term credit to the business community. Moreover, as a mercantilist, Hamilton believed in a strong central government that would actively

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