Deregulation, Innovation, and New Competition in Financial Services Markets: An Overview

B. Frank King, Research Officer at the Atlanta Federal Reserve Bank, describes the current process as an integration of financial markets across institutions and space. This integration casts doubt on the conventional regulatory definition of commercial banks — as institutions offering a unique cluster of services in a market limited to local competitors.

Discussions of our changing financial system have become quite common in recent months. Experts and laymen alike are trying to understand such new things as NOW accounts, money market mutual funds, cash management accounts, and explicit pricing of financial services. In recent years deregulation, most clearly demonstrated by the Depository Institutions Deregulation and Monetary Control Act (the "Deregulation Act"), has broadened the services potentially offered by financial institutions. Innovative financial arrangements, such as the money market funds, have further blurred institutional and geographic distinctions and overcome legal and geographic barriers that have long inhibited financial institutions.

Wider powers for financial institutions, relaxation of barriers to geographic expansion, innovative financial arrangements, deregulation of interest on deposits, and more explicit pricing of financial services can all be expected to have impacts on how the financial system operates. These changes seem likely to produce more competition among financial institutions, increasing the number and types of competitors in many markets for financial services. By increasing the number and types of competitors and by providing opportunities for institutions to enter new markets, the changes may also influence the soundness of individual institutions and the stability of the financial system. More broadly, one would expect such changes to affect the cost of producing and delivering financial services, their prices, their availability, and the process of innovation of new financial arrangements.

The Federal Reserve is vitally interested in competition and safety in financial markets and in the performance (overall efficiency) of financial markets and the financial system. In a period of rapid change, however, any regulator's ability to analyze and decide issues of competition, safety and performance declines. There are too many new factors with unknown implications. History offers little guidance. New factors and unknown implications call for research, and research calls both for properly stated questions and for information. In this issue, we attempt to state some researchable questions about the implications of new competition for financial services.

To start, let us review briefly some elements of the new competition and how the Federal

Reserve is involved in it. The process that is going on in our financial system is an integration of financial markets across institutions and space. Some of the integration is coming about because changing laws and regulations are conducive to it. Some of it is coming about because innovators have found new ways of profitably providing financial services.

Deregulation Act

The centerpiece of deregulation so far is the Deregulation Act of 1980. By providing NOW accounts, consumer lending, and peripheral powers for savings and loan associations and mutual savings banks nationwide, and by affirming share draft account powers for credit unions, it tripled the number of institutions potentially offering a "full line" of consumer financial services. All of these institutions will not offer all services, but there is evidence that the number of competitors in some markets is increasing significantly.

The Deregulation Act also schedules the phase-out of interest ceilings on time and savings deposits. While many would agree that the long-run implications of this are positive, few are confident that the transition problems will not be serious. Other significant aspects of the Deregulation Act are its provision for limited business lending by savings and loan associations and mutual savings banks and pricing of Federal Reserve services. Both provisions are likely to increase the competitiveness and efficiency of the financial system.

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The Deregulation Act is the most dramatic of the new innovations. There is, however, a steadily lengthening list of changes that serve to add competitors, broaden geographic spread of institutions' markets, and offer new ways of accomplishing financial arrangements.

Redrawing the Financial Services Map

On the funds gathering, or deposit side, new competitors include institutions that were not found in lists of competitors of depository institutions even five years ago. The dramatic growth of money market funds and the recent strong reaction to them by bank and thrift institution managers demonstrate the money funds' role as competitors for deposits. A brokerage firm advertises a cash management account which ". . . may be the most important financial innovation in years" — another deposit competitor offered nationwide by a nondepository institution. American Express' widespread cash dispensers and more easily available commercial paper are additional competitors in deposit markets that were once virtually the sole province of banks and thrifts.

On the loan side, we find older institutions offering more services and expanding geographically. Loan production offices, representative offices, nonbank operations, and Edge Act corporations of large banking organizations have been rapidly expanding across state lines into areas where the organizations may not accept deposits. Commercial and captive finance companies (finance companies owned by producers, such as auto or farm equipment manufacturers) have reportedly expanded from their traditional equipment financing function to offer receivables and inventory financing in some parts of the country. Citibank's nationwide credit card distribution expands that

organization's consumer lending well beyond the state in which it is headquartered.

The Regulators' View

These integrating forces have to be met at several points by financial regulators. In the new environment, some of the banking agencies' assumptions about competition may be outmoded. In their analyses of competitive impacts of these transactions, for example, the agencies have treated commercial banks as offering a unique cluster of services in a market limited to local competitors. Only local banks have been considered competitors. The changes just described cast doubt on all three characteristics assumed for bank competition: uniqueness, clusteredness, localness. Yet the conventional treatment has been accepted by the U.S. Supreme Court in several decisions.

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We cannot just write the treatment off without evidence. Evidence of change in the structure of financial markets is certainly relevant; however, that is not sufficient for the Federal Reserve's policy or interests. Basic to antitrust law and its enforcement is an assumption about the efficiency of markets. As a policy objective, market structure for its own sake is secondary to the performance of institutions and markets. That points to a need for evidence about the changing structure's impact on the performance of markets and institutions. It is needed not so much to convince the Supreme Court but to tell us how to analyze bank acquisitions and mergers, how to regard the expanding nonbank activities of bank holding companies, and whether to hasten or deflect the move toward interstate banking.

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Recent changes in the financial system have safety implications also. New entrants in activities where larger size leads to greater efficiency are likely to threaten some institutions. Add to these factors competitive pressure to develop new products and the cost of introducing new products; stir in sharply fluctuating interest rates, and you have at least the possibility of problems among financial institutions. Where, when, and how are significant problems likely to emerge? How should they be dealt with in order to ensure both stability and efficient performance at the same time? Evidence is not clear yet.

More generally, there are two important issues. How efficiently will the financial system operate during and after this period of change? Will the system be able to handle new conditions innovatively and soundly? The following articles identify more specifically the questions we need to ask as we deal with these central issues. ER

—B. Frank King