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THE BALANCE OF CHANGING REGULATORY AND COMPETITIVE PRESSURES

Remarks of

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The Balance of Changing Regulatory and Competitive Pressures

There have been a number of bank regulatory changes in recent years aimed at increasing the ability of the banking system to adapt to changing financial market conditions. In addition, the rapid growth and spread of bank holding companies has substantially altered the structure of banking in the U.S. These changes have brought both benefits and some less desirable consequences to the banking industry. I find it useful from time to time to step back and weigh the benefits against the costs of these regulatory and competitive changes, and to consider what further steps might be appropriate to consolidate the gains or to alleviate some of the adverse effects of what has already been done.

Regulatory Changes

Among the recent regulatory changes that are particularly relevant in this context are (1) the elimination of all rate ceilings on large denomination CD's in 1970 (on maturities under 180 days) and in 1973 (on maturities over 180 days), (2) the substantial increase in 1973 in the rate ceilings on small consumer CD's with maturities in excess of 2-1/2 years,[1/] (3) the regulatory and operational changes,

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1/ Prior to 1973 the ceiling was 5-3/4 on all CD's under $100,000 with maturities in excess of 2-1/2 years. These ceilings have gone to 6-1/2% for 2-1/2-4 year maturities, 7-1/4% for 4-6 year maturities, and 7-1/2% for maturities of at least 6 years.

such as NOW account and telephone transfer powers, that are permitting the use of time and savings deposits for transactions balances, (4) the reduction in the reserve requirements on Eurodollar borrowings from foreign banks from 20 percent in 1971 to 8 percent in 1973 and 4 percent in 1975, and (5) the reduction to 1.0 percent in 1975 in the reserve requirements on time deposits with maturities of at least 4 years. In addition, the Board and other regulators have taken a tolerant hands-off attitude toward the federal funds market, in effect permitting unlimited purchases and sales of federal funds without collateral (except as limited by Section 23A), without rate ceilings, and without reserve requirements.

In the competitive area, the dramatic extension of holding companies to the point where over 65 percent of all banking assets are now in banks affiliated with holding companies, has served to increase competitive pressures in a number of banking markets. In addition, the success of nonbank institutions to enter certain traditional banking markets, has increased competitive pressures on some banks. For example, money market mutual funds now compete for short-term savings and the NOW accounts for what are essentially demand deposits.

Public Benefits

There have been significant public benefits resulting from these regulatory and competitive changes. The complete rate freedom on large CD's has made it possible for banks to retain deposits that could otherwise have been drawn out of the banking system by high interest rates. Because of the importance of bank loans as financing for small and medium size businesses, which do not have access to commercial paper and private placement markets, such continued funding has been of some importance in avoiding a disproportionate impact of tight money on such bank loan customers. The significance of large CD's as a source of bank loan funds can be seen from figures showing the contribution made by large CD's to the increase in bank loans in 1974, when interest rates hit their peak. The total increase in bank loans during 1974 was $52 billion, and the $27 billion increase in large CD's outstanding equalled over 50 percent of these funds. In 1973 a $21 billion increase in large CD's reached 29 percent of the increase in outstanding loans in that year. However, 1974 bank loans provided 38 percent of the net increase in private domestic credit, down substantially from the average of 45 percent in the preceding two years. If banks had not been free to raise open market funds through large CD's, the role of banks as lenders would have been further reduced, perhaps disadvantaging bank customers who have no realistic alternative for credit.

The freedom to engage in federal funds transactions has also been important as the funds market gives banks an extra flexibility to raise liabilities so that they can fund loans when demand is high. Furthermore, by enabling banks to derive earnings from overnight placement of funds, it makes possible higher bank earnings, lower interest rates on loans or a combination of the two.

There are also potentially important public benefits in subjecting banks to the discipline of the competitive market place. Interest rate competition between banks as well as competition from new institutions or those with new and vigorous management help to achieve a better combination of earnings and service to depositors and competitive interest rates for loan customers. Thus, the recent regulatory and competitive changes have helped to increase efficiency in financial markets.

Disturbing Trends

However, a number of disturbing trends have also been observed during recent years, and one might wonder if the impacts of some of the recent regulatory actions may have permitted bank actions which created these problems. Among these disturbing trends are the dramatic increase in bank reliance on potentially unstable purchased money liabilities, the increased number of banks experiencing some degree of financial distress, and the erosion of capital ratios thus reducing the ability of the banking system to weather serious adverse shocks.

The heavy reliance on purchased money has been most striking among the largest banks. At the end of 1974 the average borrowing ratio of large New York banks, the ratio to assets of their large negotiable CD's, Federal funds purchased, and obligations to foreign branches, averaged 36 percent constrasted with 26 percent for the large weekly reporting banks outside New York and a much lower ratio for smaller banks.[2/] This borrowing ratio of the large New York banks has declined modestly to 34 percent at the end of 1976, but even this level was much higher than the 22 percent average borrowing ratio that prevailed among these banks at the end of 1971. As these figures are averages, some individual banks clearly have had even higher borrowing ratios.

The financial distress of portions of the banking industry has been evident to everyone. While average bank profit figures generally rose through 1974, held steady in 1975, and rose again in 1976, net loan losses were well above normal in these years. Despite the generally good earnings, the percentage of banks reporting no net income before taxes grew from less than 3 percent in 1970 to 7.9 percent in 1975 and over 8 percent (1200 banks) in the first six months of 1976. This trend has existed among large as well as small banks.[3/] Bank failures, the extreme form of financial distress, increased in 1975 and 1976, but were still insignificant in relation to the entire banking system.

2/ On March 31, 1976, the only date for which comparable data are readily available for all banks, this borrowing ratio was 12 percent for "all other" (not large) member banks and 11 percent for nonmember banks.

3/ Over 1000 banks in the size class with assets under $50 million (8 percent of that size class) reported no income before taxes in 1975. Also, 8 percent of banks in the $1 billion to $5 billion asset size class reported no income before taxes in 1975.

The potential exposure of the banking industry to adverse shocks shows up in two ways. First, increased dependence on purchased money liabilities clearly holds the potential for severe cash flow problems for a bank that for some reason becomes a concern to the money market. Also the capital base of the banking system, its equity capital, reserves, and subordinated notes and debentures, has declined steadily for a number of years as a ratio to total assets, falling below 7 percent in 1974 on the average for all banks having over $100 million in deposits, and close to 6 percent for the largest banks. Although the capital ratios of large banks have improved somewhat since then, the gain has been modest.

To some degree the banking industry is exposed to the financing of one bank by others. Thus, a bank with a large purchased money position often relies upon the continued availability of federal funds from other banks. Such an exposure may suffer both from the funding needs of other banks and from their perception of the soundness of the heavily committed bank.

Increased competition for consumer deposit business has been most evident, in Massachusetts and New Hampshire, home of the NOW account. In those states bank incomes before taxes or security gains dropped 36 percent in 1975 from their 1974 level, contrasted with a 13 percent drop in the other New England states and a slight increase nationwide. In the first half of 1976 bank incomes fell further in Massachusetts, while holding steady on the average in the rest of New England and rising in the U.S. as a whole. We should note, however, that the recession hit the northeastern states, especially Massachusetts, particularly hard, and bank earnings declines reflect that too.

The competitive force for expansion into nonbank fields probably led some holding company managements into unwise acquisitions. The increased competition resulting from this expansion may have been a factor in the current problems of some bank holding companies and may have contributed to a few failures. The regulators' insistence upon increased competition may have exposed some banking units to excessive pressure and thus encouraged competitive forces to dominate banker responses.

Was Regulatory Change Responsible?

The crucial questions raised by these problems are what role regulatory liberalization may have played in generating these problems and where we should go from here.

There is little doubt that the removal of rate ceilings on large CD's and the liberal attitude toward regulation of federal funds have been of central importance in enabling banks that are so inclined to incur very substantial purchased money obligations. They simply could not have done so under more restrictive regulatory conditions. It is not possible, however, to connect this increase in purchased money obligations in any simple way with financial distress in the banking system. While it may have played a role in isolated cases, heavy use of purchased money has not been associated in general with falling or low profits. As a group, large banks have had the highest borrowing ratios over the past three years.

Nevertheless the averages hide substantial diversity among banks. As noted earlier, the number of banks reporting no income has been rising in all size classes, and the predominant cause of losses for banks has been poor loans. Did the high cost of purchased money force some banks into making unwise loans in an attempt to maintain a good spread of revenues over costs? Did the freedom to buy purchased money, and a competitive desire to maintain or expand market share, tempt them to make unwise loans that they would otherwise have turned down? If banks had been restricted by regulation from dealing so heavily in purchased funds, would fewer bad loans have been made?

Fewer loans of all kinds, bad or good, would have been made under more strict regulatory control, because bank asset growth would have been more strictly limited. And it may well be that poor risks would have been more effectively screened out, with the earnings of the weaker banks holding up better than they did. But would that have been a desirable outcome, to restrict more tightly the growth of bank lending during years of recession?

Capital Adequacy

Again it comes down to a matter of weighing benefits and costs. Risk taking is essential if the banking system is to fulfill its role. Consequently, some banks will inevitably suffer losses. The ability of banks to absorb heavier than normal losses one year and move on depends ultimately on earnings and their capital positions. And here lies one of my concerns--do present laws and regulations deal adequately with the issue of bank capital?

As I mentioned before, bank capital as a percent of assets has been declining steadily for years, except for a modest increase in 1976. Furthermore, I would not want to argue that the period of pressure on bank profit margins and losses for individual banks has ended. As the economy heads up onto higher ground the competitive pressures in banking will intensify. Deregulation is in the air and for banks that might mean full scale competition from thrift institutions, interest on demand deposits or at least on NOW accounts, and possibly even a federal branching amendment to the McFadden Act. If you add to that the electronic funds revolution--which under certain configurations and in certain impacts may work to the advantage of thrift institutions and against their commercial bank competitors--you have the ingredients of very heavy pressure on bank profits in the next decade. I already reported what has happened to the profits of Massachusetts and New Hampshire banks, and although I do not know how much this was due to NOW account competition, I would guess it played some role. If the same thing should begin to happen in other regions, is bank capital adequate?

Nobody knows how much capital is "adequate," in an absolute sense. But I do know that more capital is more adequate than less capital, and I also know that it is not just the stockholders and investors of a bank that suffer if that bank gets into severe difficulties because of inadequate capital. One of the obvious consequences of a regulatory framework that places no limits on purchased money liabilities is that banks can leverage capital, subject only to market restraints. It enables them to pile large quantities of potentially volatile liabilities and loan assets on top of a fixed capital base. The possible consequences of that trouble me.

What can be done to encourage banks to build up their capital base, especially their equity base? Part of the problem lies in the structure of the corporation income tax, which has favored debt capital at the expense of equity, for nonfinancial as well as financial corporations. This distortion is usually mild when there is no inflation, but it becomes far more severe when inflation drives up interest rates on debt and the tax system makes all that interest deductible. Whatever may be the difficulties with making dividends at least partially deductible, or with changing the corporation income tax in other ways to improve the attractiveness of equity finance--and I am sure the difficulties are many--it would make equity expansion more feasible for banks.

Other proposals that have been suggested for years, and that might deserve a new look, are deposit insurance premiums that are higher for banks with low capital ratios and supplementary reserve requirements on purchased money liabilities--or all liabilities--that exceed some multiple of the bank's capital base. Indeed, graduated reserves beyond a specific level of purchased money ratios to gross loans or short maturity assets might be a way of achieving some control over the flagrant abuses. While I am not convinced that any of these steps would, on balance, be the best action, they would probably work in the right direction.

Inhibiting Corrective Moves by Regulators

Another aspect of the purchased money expansion that troubles me is its potential for inhibiting necessary moves by regulators in the case of individual problem situations. In such cases the regulators considering a cease-and-desist order, a denial of a holding company acquisition on financial or managerial grounds, or some other regulatory move which will become public must always weigh the benefit of the move against the possibility that public knowledge of the move will compromise public confidence and may generate a run on the bank's liabilities. The more volatile a bank's liabilities, and the greater the proportion that are not covered by deposit insurance, the greater the danger of a run causing rapid deterioration of a bank's liability base. Obviously, purchased money obligations are substantially more vulnerable to this problem than regular deposits. It troubles me that the very heavy reliance on purchased money in a number of banks may not only create severe financial stresses for some of them but may also make it difficult for the regulators to step in when necessary.

So once more I am put into the dilemma of weighing benefits and costs, for this is certainly a cost of some magnitude. Should more restrictions be put on the use of purchased money for this reason?

There are other ways of attacking this dilemma, each with its own problems. One might, for example, extend deposit insurance to all large CD's, or to all deposits. Then even a troubled bank should be able to turn over its CD's when they matured.

But this would surely require some restructuring of the schedule of insurance premiums, which are currently based on total deposits rather than insured deposits. Extending insurance to all deposits, including large CD's, without a change in the premium structure would convey a benefit to large banks at the expense of their smaller competitors, since large banks are proportionately more active issuers of large CD's. In order to preserve the present balance among banks it would be necessary to charge a higher or supplemental insurance premium on large deposits.

Full deposit insurance would also have the disadvantage of removing an important source of market discipline on banks since large depositors would no longer have to scrutinize their banks' soundness when deciding where to place their funds.

More broadly speaking, the problem posed by the threat of rapid withdrawal of purchased money obligations arises only because a bank's assets are not equally liquid. Thus the seriousness of this problem can vary widely from bank to bank depending on the turnover rate of each bank's loans and the quantity of marketable investments it holds. If each bank employing large quantities of purchased money obligations used these funds to acquire very liquid investments, then the purchased money would not pose any liquidity threat.

This is unrealistic, of course. But it brings out the point that part of the difficulty with purchased money is not its high cost but its very short maturity and the fact that its use tends to aggravate the maturity imbalance between a bank's assets and its liabilities. To a considerable degree banks are engaged in borrowing short and lending long, especially in terms of the turnover and liquidity of their funds, just as are nonbank thrift institutions. The maturities on both sides of the balance sheet are shorter for banks, but the imbalance is similar, and purchased money can make the imbalance worse.

Where am I leading with this? I am looking for some way to portray in broad terms the web of difficulties that the purchased money explosion creates for regulators, and the question in my mind is whether there may be some possibility of dealing with these difficulties as an issue of portfolio balance, considering assets and liabilities together.

If one takes this approach, a couple of crude possibilities suggest themselves. Deposit insurance premiums that vary with the degree of maturity imbalance between a bank's assets and liabilities would be one possibility. Another would be to limit purchased money obligations to some multiple of a bank's cash and marketable securities, call loans, and other very liquid assets. Also of some relevance in this context are moves to encourage the lengthening of other liabilities, and the 1973 increase in the rate ceilings on small consumer CD's with maturities in excess of 2-1/2 years has had just this effect. Such small denomination consumer CD's increased from 3 percent of total commercial bank deposits in mid-1973 to 9 percent in mid-1976. Also, access to the discount window of the Federal Reserve may moderate the impact of a withdrawal of such money.

Conclusion

Where does all this leave us? I think it leaves us with a series of tough questions to ponder about what have been the benefits and costs of recent banking regulatory and competitive changes. It also leaves us with a sense that the regulatory structure is constantly evolving and constantly in need of reevaluation. Each new change in the regulations creates another round of difficult issues.

This analysis obviously argues for great caution in making important regulatory changes or in imposing further competitive pressures. While some advantages and disadvantages of each move are readily apparent, there are others, particularly at the individual bank or depositor level, which are not clearly discernible. Over the next months and perhaps years, we will be trying to determine the balance of costs and benefits of a number of potential new changes. Among those proposed are payment of interest on demand deposits or nationwide NOW accounts, the extension of reserve requirements on all transaction balances, and payment of interest on reserve balances, renewal or abolition of ceilings on interest rates on time and savings accounts, removal of the differential on rates authorized for thrifts against banks, and extending checking account powers and new lending authority to thrifts and credit unions.

Extraordinary care will be required to measure the impact of a package of changes and the timing of such moves. Also important will be the need for measurement of public and institutional reactions. Our complex financial structure with its inter-relationships, checks and balances of power, and special management expertise, could be upset by hasty or sweeping reforms. Just one example might demonstrate the complexities. Were there nationwide NOW accounts on which financial organizations held required reserves that earned interest, there could develop new instabilities in competitive positions or cost and price uncertainties in the relationships between thrifts and banks, between correspondent banks and the Federal Reserve, and between customers of one institution against those of another. On the other hand, there are potential benefits to this formulation of change including the competitive thrust in financial organizations, the increased equity of interest payments among differing groups of depositors, and to the equity between the member and nonmember banks. The balance between the potential costs and benefits will require careful analysis and appraisal by all of us.

Finally, this review highlights the fact that there is both conflict and complementarity in the relation between regulation and the forces of market discipline. In spite of its importance in achieving improved efficiency, releasing the full forces of market discipline on a regulated industry can cause serious difficulties and can be overdone. There is always a need to measure and balance the benefits of increased competition against the enlarged costs and exposure to the banking system and individual banks.

On the other hand, if a fundamental decision is made to bring greater competition into a regulated industry, it is often possible to shape new regulations so as to channel and direct the competitive forces in ways that will best serve the public without entailing costs greater than the expected benefits.

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