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BANKING IN THE 1980s AND BEYOND: MANAGING FUTURE SHOCK

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BANKING IN THE 1980s AND BEYOND: MANAGING FUTURE SHOCK

by William M. Isaac*

Today I would like to discuss the general direction in which the banking industry seems to be headed and some of the public policy issues we should be considering as we seek to shape our new financial services environment. It has become almost passé to predict that the financial services industry will undergo major structural changes during the next decades. The real question is not whether we will experience substantial change, but rather, "what form will it take and how fast will it proceed?" How will we get from today's highly-regulated market, with specialized lenders, to a less regulated, presumably more competitive market where specialization will be a matter of free choice, not one mandated by law?

In the closing chapter of Future Shock, Alvin Toffler writes:

> This ...is the turning point in history [where] man either vanquishes the process of change or vanishes.... Being the unconscious puppet of evolution he becomes either its victim or its master....A challenge of such proportions demands of us a dramatically new, a more deeply rational response toward change.

This passage may be too dramatic; the choice may not be black-and-white -- between "victim" or "master" of change. Yet, the challenge and the message which Toffler directed toward society-at-large is particularly relevant to the banking industry today. We must conscientiously and constructively address the management of change or succumb to "future shock."

I believe basic changes in the structure -- in the rules of the game -- of the financial services industry are both necessary and inevitable. It will not matter whether you or I am for or against change. It will not matter if we attempt to promote or defeat legislative initiatives. The marketplace and innovative competitors will prove to be a relentless force in the continuing evolution of the financial services industry. We are all caught up in the process of change and the most we can expect to do -- and the very least we should do -- is shape events and channel them in one direction or another.

It is in this spirit that I would like to discuss the future of the banking industry. The central theme is change, and the primary force is the competitive deregulation movement. This discussion will raise a number of issues which involve sometimes competing public policy objectives worthy of consideration and debate. There are no easy answers.

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*The views expressed are personal and do not necessarily reflect F.D.I.C. policy.

The longer I am in my position at the FDIC and the longer I grapple with public policy issues, the more relevance I find in Peer's Law:

> The solution to a problem simply changes the nature of the problem.

The Deregulation Movement

The competitive deregulation movement encompasses two major elements -- interest rate controls and restraints on geographic expansion. I will highlight the wide range of public policy issues that are raised by the movement to remove these legislative restrictions on the industry, beginning with the restraints on geographic expansion.

Restraints on Geographic Expansion

The debate concerning the elimination or phase-out of legal barriers to geographic expansion has been brewing for many years. By now we are all aware of the potential advantages of eliminating artificial restraints on geographic expansion, whether through additional branching powers or the bank holding company vehicle. Such a change would tend to:

(1) create a more competitive environment in local banking markets;

(2) permit banks to compete more effectively with unregulated or less-regulated domestic and foreign competitors;

(3) allow banks to provide more convenient services to consumers and other customers;

(4) facilitate a more direct and efficient flow of funds from areas with credit surpluses to areas with credit deficiencies; and

(5) provide for greater domestic growth opportunities in the banking business rather than forcing banks into more distant product and geographic markets.

There are other potential advantages which could be added to this list. There are also many people who would disagree strenuously with these points. I do not want to become embroiled in a debate between change and the status quo -- it will ultimately prove to be an empty one. Rather, I would like to focus on the major public policy issues involved in any decision to revamp our laws relating to the geographic expansion of banks. In my opinion, serious consideration must be given to the potential impact on: one, the concentration of resources; two, the safety and soundness of the system; and three, the federal bank regulatory structure and the dual banking system. Let me emphasize again that my purpose in raising these issues is to help fashion a rational process for change.

First of all: "What are the implications for the concentration of resources in the financial industry?" I believe that a less-regulated environment will produce more competitive local markets -- at least in the short run. As larger banks enter new markets, they generally increase the intensity of competition and raise the level of service to bank customers. Yet, given the opportunity, the larger banks tend to grow by acquisition, rather than by de novo entry, and normally the larger the acquisition the better. The community banks frequently accept the large bank overtures -- it is often an offer too good to refuse. In the long run, this could lead to a much more concentrated, and less competitive, banking industry.

Economic theory aside, I am concerned about excessive concentration of economic and financial power on socio-political grounds. America has one of the most open and upwardly mobile societies in the history of the world. In my judgment, this has been due, in no small measure, to a relatively diffused power structure within the country. Although they were focused primarily on the church and the public sector, our fore-fathers built many safeguards into our Constitution in a conscious attempt to avoid concentrations of power. Over the years, events have moved us away from these precepts, and our society seems to have grown more rigid in the process. I believe, however, that we must constantly strive to preserve this ideal.

Relaxing the current restrictions on geographic expansion raises a second public policy issue. We must ask: "What are the implications for the safety and soundness of our banking system?" On the one hand, larger organizations will likely evolve and it is frequently argued that larger firms attract more able managers, better diversify risk, have greater access to the financial markets, and are less vulnerable to such occurrences as abusive insider transactions. On the other hand, if competition should intensify -- which would be the major goal of any revision in the laws -- banks could become more exposed to the vagaries of the marketplace. We could well experience more bank failures and emergency mergers.

If the structure of the banking system were dramatically altered, we might also experience a more subtle impact on safety and soundness. The general public does not impose significant marketplace discipline on the banking system. A sufficient amount of timely information about most banks is not generally available for a proper evaluation. The general public lacks the experience to digest the information it does receive and, in any event, it assumes that the deposit insurance system will handle any problems. An important source of marketplace discipline today is derived from our correspondent banking system. As excess funds are transferred from one bank to another -- typically from smaller community banks to regional correspondents and then to the money center banks, but frequently in the other direction as well -- the recipient banks are normally subjected to a more sophisticated credit analysis than could be made by the general public. If a few large banks were able to gather funds directly through branch operations, might we not lose a degree of marketplace discipline? If so, how and by whom would the vacuum be filled?

Finally, in evaluating a decision to liberalize restraints on geographic expansion, we must ask ourselves: "What are the implications for our dual banking system and the federal bank regulatory structure?" Interstate banking could increase the pressures on state banking commissions, perhaps substantially weakening them as demands increase for a more coherent and consistent regulatory framework. At the federal level, the pressure for a single, more powerful agency might intensify in order to provide for comprehensive oversight and responsibility.

Having made all these observations, one must address the really tough questions: How do you reconcile a desire for a more competitive, more responsive banking system with a desire to preserve our regional and community banks? How do you reconcile a desire to free banking from the shackles of unrealistic restraints with a desire to avoid concentrations of power? How do you allow the industry to keep pace with changing times and not unduly disrupt the present, rather delicate competitive balance, the correspondent banking network, or the dual banking system? I would suggest several guidelines:

(1) states which have not recently addressed these issues should do so promptly to ensure that their banking laws allow flexibility for financial institutions and vigorous competition -- at least in states with major financial markets, reciprocal interstate banking arrangements may be appropriate;

(2) change the laws gradually in a way designed to allow smaller banks to adjust and to play "catch-up;"

(3) reduce the regulatory and paperwork burdens which disproportionately impact on the community banks;

(4) reconsider regulatory policies, such as those relating to capital adequacy, which may place smaller banks at a competitive disadvantage; and

(5) consider strengthening the antitrust laws relating to acquisitions of going concerns by the larger financial institutions.

If we do not anticipate the ramifications of change and take properly planned measures, perhaps along the lines I have suggested, the deregulation issue may provide a "Catch-22". Imagine, if our system were to evolve to one with substantially fewer and substantially larger banks. Increased concentration of power in the private sector is invariably matched by increased government intervention. Should such a system develop, the government would likely become more directly interested in precisely how banks are operated, and toward what end. We could wind up with a concentrated industry closely governed by a powerful federal agency. Many countries already have such a system and America may be headed in that direction. Instead of deregulation we could well bring down upon ourselves the ultimate in government control.

Interest Rate Controls

The second major element of the deregulation movement concerns interest rate controls. Some banks paid interest on deposits in the early 1800s, but the practice of paying interest on consumer demand and time deposits became common after 1913 as competition for these funds intensified. Almost immediately there were calls by bankers and bank regulators to control rates in order to avoid destructive competition. Numerous legislative initiatives failed until, in the midst of the banking crisis of the 1930s, interest rate control legislation was finally passed. It was said controls were necessary to prevent the destructive competition which led to the massive bank failures. Afterward, studies such as Lester Chandler's "America's Greatest Depression" and Al Cox's dissertation, "Regulation of Interest Rates on Bank Deposits," indicated that excessive rate competition was not an important factor in the banking crisis.

Interest rate controls worked fairly well during the first 20 years or so of their existence because market rates were generally in line with the controlled rates. However, on a number of occasions since 1957 market rates have risen above Regulation Q ceilings, causing increasingly severe pressures on Regulation Q. It has been argued, with a good deal of force, that Regulation Q ought to be phased out because:

(1) it creates disintermediation with its attendant problems;

(2) it results in a misallocation of our financial resources; and

(3) it subsidizes borrowers (particularly higher-income borrowers) at the expense of savers (particularly lower-income savers).

I am convinced that Regulation Q cannot survive much longer and that interest rate controls will be phased out in one way or another. Action in this area will raise a number of important public policy issues. The implications for the safety and soundness of the banking system, for the availability and cost of credit to particular market segments, and for the conduct of monetary policy must all be considered.

First of all, "What are the implications for the safety and soundness of the banking system?" In a "Q-less" environment, marginal banks will be free to offer whatever it takes to attract funds. Consumers and small businesses, lacking the information or expertise to evaluate the condition of those financial institutions, and relying on our deposit insurance system, might find such offers very attractive. In other words, the marketplace might not provide an effective check against such practices. Recognition of this potential has led Britain to adopt a deposit insurance plan which provides only 75% protection against loss to depositors, up to the insurance limit, rather than the 100% protection that we provide in the U.S., up to the $40,000 limit. The British feel that this "co-insurance system" will preserve a greater degree of discipline.

The ability of thrifts and small banks, which tend to have a relatively fixed-rate asset structure, to adjust to a decontrolled rate environment is another safety and soundness-related issue that should be addressed. Any change should be phased in to allow time for the many adjustments that will be required. We must liberalize the asset powers of thrift institutions and consider more flexible mortgage instruments such as variable rate mortgages and graduated payment plans. Another important question is how do we reconcile the conflicts presented by usury laws? To allow the rates paid on deposits to fluctuate freely while constraining the rates charged to the traditional loan customers of thrifts and community banks would present a very serious threat to the viability of those institutions.

Moving from safety and soundness into other areas we must ask: "What are the implications of interest rate decontrol for the affordability of housing to moderate-income families? -- or for the continued availability of credit to small businesses and farmers?" Direct subsidies and tax incentives may be the answers to some of these problems. Finally, we must consider the implications of interest rate decontrol for the conduct of monetary policy. Our experience with money market CDs and automatic transfer services suggests that, at the very least, decontrol will cause some temporary distortions in data.

Reconciliation of the competing policy objectives -- to provide a more efficient allocation of our financial resources and a greater incentive for the saver in these inflationary times, to maintain confidence in the financial system, and to preserve the availability of credit to particular markets -- poses some tough trade-offs. I believe an approach which allows for an adequate adjustment period and directly addresses the ripple effects of change is to be preferred.

As we deal with the fundamental issues raised by the competitive deregulation movement, we must keep in mind that our present financial structure has evolved over a long period of time. We did not get where we are purely by historical accident; our present system is the product of a good deal of thought, debate, and political compromise. Times change, however, and the system must also change -- or perish.

An Ironic Twist: The Social Regulation Movement

During the past decade, the federal bank supervisory agencies have become increasingly involved in the consumer and civil rights protection business -- even to the point of intervening to a certain extent in the credit allocation process. This trend is evidenced by the Truth in Lending Act, the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Fair Credit Billing Act, and the Community Reinvestment Act. It is also evidenced by greater concern for equal employment opportunities and increased efforts toward investor protection.

In part this is merely a reflection of the larger social movement which began in earnest in this country in the 1960s and has continued into the 1970s. The movement has spread throughout the world -- many countries' banks and bank regulators are struggling with the same issues that confront us.

Ironically, however, these laws and regulations in the banking field also seem to be a by-product of the same marketplace forces that are breaking down government regulation of competition in banking. Banks have moved swiftly into new product markets and have made credit available to consumers on an unprecedented scale. This has brought the banks under the direct purview of the consumer protection movement. As credit has become an increasingly important element in the daily lives of more people, the government has taken a much greater interest in how and to whom that credit is or is not dispensed. Depending on your point of view, that might or might not be a desirable development -- but it is reality. I hope that we will be able to streamline and simplify many of these measures and even eliminate those that are unduly burdensome, but I do not envision a reversal of the basic trend.

Much has been, and still can be, said about the social regulation trend and what banks can do to better cope with it. My purpose is simply to note that this trend is distinct from the movement to decontrol competition and is not likely to be greatly affected by it. An increase in the level of competition in banking will eliminate some of the need and justification for regulation in the compliance area, but I doubt that the impact will be very substantial.

Management of Change: The Strategic Question

Let me conclude today with some summary remarks about the management of change. The forces of change are coming at us from every direction, and one cannot simply wish them all away. Social pressures and headline-catching abuses have led to more regulation of banking practices in the areas of consumer affairs, civil rights, and ethical responsibilities. Continuing inflation has pushed market interest rates higher, putting banks restrained by Regulation Q (particularly non-money center banks) at a competitive disadvantage, penalizing savers, and fostering growth of non-deposit sources of funds. Bank holding companies, Edge Act Corporations, loan production offices, and other devices have provided the vehicle for many firms to establish a nationwide financial services presence despite the McFadden Act and Section 3(d) of the Bank Holding Company Act. A virtual revolution in communications and transportation technology has "internationalized" the world's business community, including banking. The discussions currently underway, the bills that have been introduced, and the studies that are progressing, all point toward continuing legislative and regulatory initiatives. Time and events are on the side of change. Our challenge is to mold those changes; it is an important and difficult task, indeed.

The task is made all the more difficult because each decision impacts on another decision -- and the risks of not correctly anticipating the ultimate outcome of our collective actions are serious. Our financial system rests on the confidence of the general public, and on our confidence in our business partners and in ourselves.

The complexity of the interrelationships can appear overwhelming. Changing the structure of our financial services industry will mean disturbing the present delicate competitive balances between banks and non-banks, between large banks and small banks, between domestic banks and foreign banks, and between the federal and state regulatory authorities and banking systems. It may also have an effect on the flow of funds in our economy. The scope and complexity of the issues, the number of competing interests, and political realities have led many to conclude that the management task before us can only be tackled on a piece-meal basis -- first focusing on one issue and then another. I believe we run very real risks by addressing the future of our financial institution and regulatory structure on an issue-by-issue basis. The adjustment process could well prove painful and involve a good deal of instability.

As difficult as the task will undoubtedly be, I believe we should seriously reconsider the possibility of a reasonably comprehensive approach -- perhaps something along the lines of the Hunt Commission Report or the FINE Study. In fact, the Hunt Commission Report emphasized the importance of a rational, coordinated blueprint for change, saying:

> The critical need for competition on equal terms causes the Commission to emphasize the inter-dependence of the recommendations and warn against the potential harm of taking piece-meal legislative action.... The Commission believes that piece-meal adoption of the recommendations raises the danger of creating new and greater imbalances.

I encourage you -- particularly those of you who may not have given thoughtful consideration to these issues in the past -- to give these matters your fullest attention and to join the debate with a positive and constructive attitude. I, for one, welcome your thoughts and suggestions.