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DEREGULATION: SOME CRITICAL CHOICES.

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DEREGULATION: SOME CRITICAL CHOICES

By William M. Isaac*

Today I want to talk about something very important: the changing environment in the financial services industry and the future of your banks.

I will begin with a brief history of the evolution of the American financial system, centering on the development and the subsequent erosion of the three basic, government-imposed restrictions on competition: mandatory specialization, restraints on geographic expansion, and interest rate controls. This historical perspective is useful for several reasons. First, if we understand how certain ground rules came to be established, we can better evaluate their continuing validity. Secondly, there are lessons to be learned and mistakes that should not be repeated. Finally, by viewing the evolution of our financial system over an extended period, we recognize that change is inevitable and we bring our future into sharper focus.

After the historical overview, I will suggest some public policy issues that must be addressed if the evolution of our financial system is to be orderly and responsive to the public interest.

Let's look back, beginning with the development of specialized intermediaries.

*The views expressed are personal and do not necessarily reflect FDIC policy.

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BARRIERS TO COMPETITION

Mandatory Specialization

Specialization by depository institutions, although currently mandated by law, originated in the marketplace. The first commercial bank chartered in the United States was founded in Philadelphia by Robert Morris in 1781. Other states quickly followed Pennsylvania's lead, and by 1794 eighteen commercial banks had been chartered. These banks furnished deposit and loan services to commercial and governmental customers.

In 1816 two mutual savings banks began business, one in Philadelphia and one in Boston. At the time, commercial banks felt small individual accounts were uneconomical, so mutuals were established by philanthropists to meet the savings needs of wage earners in the industrial cities of the northeast. Mutuals encouraged thrift by paying interest on savings; it was hoped that these savings would help tide the workers over periods of unemployment. Despite the absence of charter restrictions, the early savings banks did not make loans; they invested their funds only in state and federal securities.

The first savings and loan association was organized in 1831 in Pennsylvania. This intermediary was needed to finance the purchase of homes by industrial workers who had

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neither the time nor the materials to build their own housing. At the time, commercial banks would not make housing loans. The National Bank Act of 1864 codified this situation by prohibiting real estate loans by national banks. It was felt that long-term mortgages were not appropriate for commercial banks, which had relatively short-term deposits.

Twenty savings banks failed during the Panic of 1873, resulting in adoption by the New York State Legislature of the General Law of 1875, which became the model for all mutual savings bank state laws. The law prohibited personal loans and established limitations on mortgage loans for mutuals.

During the latter part of the 19th Century, commercial banks began to accept small savings deposits and evolve into full-service institutions. During this same period, mutuals began increasing their investment in mortgages, particularly during the 1890s when government debt became scarce.

The first credit union in the United States was formed in 1909 in New Hampshire. The credit union was a cross between the early savings banks, which encouraged thrift, and the early savings and loan associations, which encouraged self-help, but with the added element of a common bond among its members. The need for credit unions arose from the lack of legitimate consumer lenders due in part to unrealistically low state usury ceilings. Both savings and loan associations and savings banks were prohibited

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during this period from making personal loans, and commercial banks chose not to do so.

The Federal Reserve Act of 1913 modified the National Bank Act by permitting national banks to engage in limited real estate lending. This authority was expanded further in 1935. Two years earlier, in 1933, the Glass-Steagall Act circumscribed the securities activities of commercial banks.

The rest is recent history and each person in this room is thoroughly acquainted with it. Commercial banks, savings banks, savings and loan associations, and credit unions have steadily expanded their activities and competition has increased among them on both sides of the balance sheet. The problems created for consumer and mortgage lending specialists by our nation's pattern of rising and volatile interest rates virtually assure that these specialists will seek additional flexibility. Thus, our nation's 14,700 commercial banks are likely to find themselves competing even more directly and more intensely with the 27,300 mutual savings banks, savings and loan associations, and credit unions.

While I have focused in this brief history on the development of four types of depository institutions, I should at least note the growing presence in U.S. markets of foreign banks and the increasing intermediation role being played by investment banking firms, credit card companies, the commercial paper market, insurance companies, finance

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companies, mortgage bankers, large retailers, and money market funds.

There is a clear lesson in this history both for the industry and for government. The marketplace is relentless in its quest to satisfy demands for new and improved products and services. If commercial banks had been willing and able from the beginning to serve the legitimate demands for consumer savings services, mortgage loans, and consumer loans, there would have been substantially less need for the nearly 28,000 specialized depository institutions that ultimately developed. If depository institutions were not constrained by Regulation Q, money market funds would be of substantially less note today. Surely the eurodollar market would be of less significance were it not for the growing cost of sterile reserves on domestic deposits as interest rates continue their secular climb. The examples are many. We ignore the marketplace at our peril.

Restraints on Geographic Expansion

Let me turn to the restraints on geographic expansion. Prior to the Civil War, there did not appear to be any strong feelings either for or against branch banking in the United States. Despite Alexander Hamilton's reservations about managerial capacity, the First Bank of the United States, organized in 1791, established eight branches in the nation's leading cities. The Second National Bank of the United States, organized in 1816, established twenty-six branches. In our early banking history, most state banks

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were established under special charters issued individually by state legislatures, so branch banking authority frequently varied from bank to bank rather than from state to state. Four of the most successful banks of their day were the State Banks of Indiana, Iowa, Missouri, and Ohio, which had statewide branching privileges.

The National Bank Act of 1864 was interpreted as prohibiting branching by national banks. This Act also imposed a stiff tax on the issuance of state bank notes and nearly destroyed the state banking system. Thus, branching almost disappeared after the passage of the Act.

Development of the demand deposit account, which largely displaced bank notes, led to the resurgence of the state banking system and, with it, branching. By 1924, 18 states permitted some form of branching, 18 states prohibited it, and 12 had no law on the subject. The Comptroller of the Currency urged Congress to equalize the competition between state and national banks, touching off a controversy which led to adoption of the McFadden Act in 1927. This Act extended limited branching powers to national banks, but state banks continued to have competitive advantages in branching. By 1932, 23 states permitted branching, 18 prohibited it, and 7 had no law on branching. The Banking Act of 1933 amended the McFadden Act to allow national banks to branch wherever state law permitted state banks to branch. The third draft of this bill contained a measure that would

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have permitted a national bank to branch anywhere within its state and into a neighboring state within 50 miles of the home office, but this provision was filibustered out of the bill. By 1936, 34 states permitted some form of branching, 9 prohibited it, and 5 had no law on the subject.

Two early devices were developed to circumvent branch banking limitations: chain banking groups and multibank holding companies. Bank holding companies flourished during the 1920s and again in the period following World War II. Legislation was enacted during the 1930s to control certain practices by chain banking groups and to require some bank holding companies to register with the Federal Reserve. The Bank Holding Company Act of 1956 expanded the registration requirements, limited the nonbanking activities of multibank holding companies, and restricted their interstate expansion. The Act was amended in 1970 to apply to one-bank holding companies and to liberalize the permissible nonbanking activities.

Banks have been motivated to expand geographically in part simply to harvest additional profits. But another goal, importantly served by geographic expansion and the accompanying growth in size, has been to develop a stronger, more diversified firm with more extensive management resources and greater access to financial markets.

The general direction in which the industry is headed with respect to geographic restraints has been unmistakable for years. Today only a handful of states do not permit

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statewide banking by banks or bank holding companies. Loan production and representative offices, Edge Act corporations, foreign branches, and so-called nonbanking affiliates have extended the reach of major banks far beyond their head offices. Advances in transportation, communications, and computer technology are rendering less and less significant the remaining legal obstacles to geographic expansion.

It is difficult to predict how fast this process of geographic diversification will proceed or the precise form it will take. But given the inexorable press of market forces against the remaining barriers, it most assuredly will continue.

Interest Rate Controls

The phase out of interest rate controls is occurring at a more rapid pace than is the liberalization of geographic restraints. Although some commercial banks paid interest on deposits around the turn of the 19th Century, the practice did not become common until the 1850s. In 1851 the Massachusetts Banking Commissioner complained that the payment of interest on deposits was draining funds from certain localities and posing potential liquidity problems for the banks buying the funds. In 1854 Connecticut adopted an interest rate ceiling of 4 percent, which remained in effect for one year. The concern spread to other states and was heightened by the Panic of 1857, which some argued was attributable in part to the movement of funds from country to city banks in pursuit of higher rates of return. Some 40

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New York City banks signed an agreement in the late 1850s to discontinue the payment of interest on deposits.

In 1869 the Secretary of the Treasury and the Comptroller of the Currency charged that the payment of interest on deposits was causing money to be funneled into risky ventures and recommended that the practice be prohibited. Legislative initiatives in the Congress to prohibit interest on deposits failed, and the issue seemed to lose its momentum until the early 1900s when the Comptroller of the Currency and the Federal Reserve became concerned about excessive rate competition. Although federal legislative efforts were not successful, a number of clearing houses, with encouragement from federal bank regulators, entered into private agreements to control rate competition, and some states adopted rate ceilings.

Finally, in 1933 in the midst of the collapse of our banking system, Congress passed legislation prohibiting the payment of interest on demand deposits and limiting other deposit interest rates at commercial banks. Although little evidence was introduced that excessive rate competition had led to the banking crisis, the final bill was adopted in less than a month without debate.

Interest rate controls were not at issue during the first 20 years or so of their existence because market rates were generally below the controlled rates. However, on a number of occasions since 1957 market rates have risen above Regulation Q ceilings, causing increasingly severe deposit

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outflows and requiring that the ceiling rates be adjusted upward.

As the rates paid by banks rose during the 1960s, thrifts found it difficult to compete for deposits. Congress reacted in 1966 by extending deposit rate ceilings to thrifts for a one-year period. Congress made clear its intent to encourage flows to the mortgage market, and the regulators implemented congressional intent by giving thrifts the interest rate differential. The rate structure established in 1966 gave savings and loan associations a three-quarter point advantage and savings banks a full percentage point advantage on savings deposits. The statute has been regularly renewed, although the rate differential has been reduced over time.

It has been persuasively argued that Regulation Q ought to be phased out because it:

(1) leads to disintermediation, particularly with respect to smaller banks and thrifts;

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

(3) subsidizes borrowers at the expense of savers; and

(4) retards competition and protects marginal, inefficient competitors.

There is little doubt that Regulation Q ceilings will be phased out over the next several years. While this raises a number of difficult public policy issues which must be addressed, there does not appear to be any realistic alternative. Market interest rates, in response to an intolerably

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high rate of inflation, have simply overwhelmed the controls. Just as the refusal by commercial banks to pay interest on small accounts in the early 19th Century led to the establishment of mutual savings banks, interest rate controls have led to the creation of devices such as money market funds which are drawing funds from banks and thrifts alike.

PUBLIC POLICY QUESTIONS

It is apparent from this historical review that deregulation in the financial field has largely occurred in response to market innovations, which have frequently emerged in circumvention of government policies. That does not mean, however, that the government will or should continue a comparatively passive role in the years ahead. A number of public policy issues have already emerged which demand attention. I will highlight some of the more important ones.

1. Competitive Structure. A host of questions can be categorized under the heading "competitive structure". It is probable that we will have fewer than 42,000 depository institutions by the end of this century. What is an appropriate number? How much consolidation are we willing to permit? How should the consolidation occur -- should we allow the larger firms to make extensive acquisitions or should we encourage combinations of smaller firms?

My personal view is that significant consolidation in the financial services sector is inevitable. This has been the experience of nations throughout the world; the movement

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in the United States is distinguishable only by the degree and rapidity of change, not its general direction.

If you believe, as I clearly do, in a strong system of community and regional banks, recent trends in our financial sector are troublesome. Not because changes are occurring -- that is the natural order of things -- but because our statutory and regulatory framework is impeding the adaptation of our regional and community banks to the new climate. As is so often the case in this kind of situation, the biggest gains are being made by the largest, most aggressive firms. The Athenian statesman, Solon, aptly described this phenomenon over 2,000 years ago when he observed that:

> Laws are like spiders' webs: if some poor weak creature comes up against them, it is caught; but a bigger one can break through and get away.

Instead of debating the wisdom of changes which are inevitable, a more fruitful approach would be to focus on the climate within which changes will take place. How fast should we proceed? Are the present antitrust laws adequate, or should they be strengthened with respect to acquisitions by the largest firms? Should we modify existing policies which preclude a bank holding company from owning a thrift and which exclude thrift deposits in our analysis of the competitive effects of a bank merger or acquisition? What can we do to ease the regulatory burdens which clearly have a disproportionate impact on the smaller banks? How do we

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make existing regulatory policies, such as those relating to capital adequacy, more fair and equitable? Would risk-related deposit insurance premiums be appropriate?

2. Regulatory Structure. The structure of our regulatory system is a second major issue with which we should be concerned. As the competition intensifies -- both among banks and between banks and nonbank intermediaries -- inefficiencies and inequities in our regulatory system become less and less tolerable. At the federal level, should we continue to have five financial institution regulatory agencies -- six if you include the S.E.C. -- or would some consolidation be in order? We may need to review, at some future time, the desirability of having three separate deposit insurance funds. Is it appropriate for bank supervisors to be so deeply involved in compliance regulation, or should this area be entrusted to an agency that has jurisdiction over a broader range of intermediaries? How do we deal effectively with multinational financial institutions?

With respect to the states, will our dual banking system serve us as well over the coming decades as it has over the past century? To what extent is it appropriate to continue deferring to the states on issues such as usury laws, branching, and bank holding companies? How do we strengthen some of the state banking departments and better coordinate their functions with those of the federal agencies?

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3. Credit Availability. Assuming that we continue to move away from our system of interest rate controls and mandatory specialization, we must also consider the potential disruption of credit flows into sectors of the economy whose credit needs might not be as well served in a free market environment. Will the farmer or small business be able to compete with the giant industrial corporation for funds? Will we be able to meet our nation's housing needs? If not, should the government assume additional responsibility? Or should we develop further incentives and subsidies to encourage the private sector to meet those needs?

4. Safety and Soundness. Deregulation, particularly the phase out of interest rate controls, also presents challenges in terms of the safety and soundness of the financial system. As competition intensifies, margins typically shrink, institutions often accept greater risks, and sources of funds tend to become more volatile. To the extent that banking has been sheltered in the past, the system can probably accommodate an increase in the level of competition. It will be essential, however, that adequate time be allowed for the adjustments that will be required of regulators, the general public, and bankers.

Bank supervisors must develop techniques for identifying and monitoring new types of activities, risks, and problems. Ways must be sought to reinstitute a greater degree of

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marketplace discipline -- to make sure that creditors have a real stake in the survival of the institution with which they choose to do business.

The American public, after experiencing about 600 bank failures per year during the 1920s and thousands of failures during the early 1930s, has grown accustomed, over the past half century, to only a handful of failures each year. How fast and to what degree can this psychology be changed?

Bankers will also make a number of adjustments in the years ahead. Banking seems certain to become a more complex endeavor, less forgiving of mistakes and inefficiencies. It will become a more challenging business with abundant rewards for success and greater penalties for failure. Management skill and good business sense will be at a premium. Good planning and marketing programs will be invaluable. Effective accounting, control, information, and public disclosure systems will become increasingly important as banks grow in size and complexity. Proper pricing of services and adequate controls on personnel and other operating costs may well be the difference between success or failure.

CONCLUSION

I want to leave you today with a few final thoughts. In the years ahead, we will not have a choice between change or no change. Changes will occur, and they will be substantial. The issue, to paraphrase Toffler, is whether we will be masters or victims of the process of change.

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Our choice will be in how we react to the new environment. There appear to be three possibilities with respect to the pending public policy issues. First, we might refuse to face up to them. This would likely injure the industry as a whole and particularly the smaller firms. A second possibility is to address the issues too late or on a piece-meal basis or to seek simplistic, expedient answers tailored to serve special interests. It is hard to predict which group might gain a temporary advantage under this scenario but in the long run we would all lose something. The third possibility is to address -- promptly and comprehensively -- the multiplicity of problems and issues confronting our financial system. While we might follow any one of these three courses, I believe it is clear which choice is preferable.

During the decade ahead a number of important actions will be taken or will not be taken concerning our financial system. If bankers participate in the political process, they will affect the outcome. I hope they will participate. I also hope that as they review these important issues and formulate their positions, they will look beyond the short-range effects on their banks, be willing to compromise, and pay due regard to the long-range interests of our nation. In the final analysis, that will benefit us all.

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