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ARE THERE TOO MANY DEPOSITORY INSTITUTIONS?

An address by

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ARE THERE TOO MANY DEPOSITORY INSTITUTIONS?

By William M. Isaac*

I recently received a call from a reporter who wanted to talk about structural issues relating to the financial services industry. We discussed a number of trends, and then he posed a frequently-asked question: "There are 42,000 depository institutions in the United States and a lot of people think that's too many -- that there must be substantial consolidation. What's your opinion?"

My response to that question is multifaceted. I am not a proponent of substantial consolidation in the financial services sector. There is no rational basis for me to conclude that 15,000 commercial banks or 42,000 depository institutions are too many. I am market-oriented, and I am concerned about the socio-political consequences of undue concentrations of economic power in our society. In the absence of compelling evidence to the contrary, I believe that a comparatively large number of smaller financial institutions is desirable, although I would be the first to acknowledge a genuine need and role for large firms. However, a number of developments have occurred, and are continuing to occur, which lead me to believe that significant consolidation may, in fact, take place over the next decade or two. How much consolidation, I am not able to predict. I hope, and genuinely believe, that well-managed

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

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community and regional institutions will continue to play an important role in our financial system. In the final analysis, however, the structure of the industry may depend ultimately on the response of public policy to the forces of change in our financial services sector.

Today, I want to expand on this response to the question of consolidation. We will have time after my remarks to discuss any issues that are of particular interest to you.

Optimal Number of Units

Let me begin by discussing briefly some of the arguments that have been advanced in support of the contention that the optimal number of units in our financial services sector is substantially smaller than the number we have today. These arguments are offered by people who assert that there are too many financial institutions in the United States -- that substantial consolidation within the industry would be in the public interest.

1. Domestic Competition. One argument is that the present fragmented structure of the industry is causing commercial banks to lose a significant share of the domestic financial services market to nonbank firms that have some advantages which banks could overcome with increased size. A frequently-cited statistic indicates that commercial banks

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owned only 37% of the assets held by private financial institutions at year-end 1979, compared to 57% at year-end 1946.*

Let us examine the data more closely. It is true that the commercial bank share of domestic financial assets declined over the period from 1946 to 1979. However, all of this decline occurred between 1946 and 1965; the percentage actually increased very slightly from 1965 to 1979.

The biggest gains were registered by the savings and loan industry, which increased its share from only 4% in 1946 to 17% in 1979. However, most of this gain was achieved by 1965, before thrifts were subject to deposit interest rate ceilings, and reflects, in part, our national commitment to housing. The market share of savings and loans may be expected to stabilize or decline when the interest rate differential is finally eliminated in six years, and when the demand for housing tapers off in the late 1980s as the demographics suggest will occur.

The second biggest gain in asset share over the postwar period was made by private and state and local government pension funds, increasing 10 percentage points from less than 3% in 1946 to more than 12% in 1979. Again, nearly all of the gain in asset share occurred by 1965. One suspects

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*Source: Federal Reserve Flow of Funds Accounts. The figures exclude foreign office assets of commercial banks and the assets of their nonbank affiliates.

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that a significant portion of these assets is under the management of bank trust departments.

Finance companies scored the next largest gain, up 3 percentage points from 2% in 1946 to 5% in 1979. Virtually all of the increase was achieved by 1965. Moreover, a number of finance companies are now owned by bank holding companies.

Money market funds, which did not exist in 1946, held more than 1% of the market in 1979. However, much of this money is reinvested in the banking system and reflects a redistribution of funds from smaller banks to money center banks and, thus, does not represent a change in the commercial bank share.

It is clear that commercial banks are being confronted with an increasingly competitive climate. As you well know, the climate is considerably more competitive today than 30 years ago. Moreover, the competition is likely to become even more vigorous in the future, and we must make every effort to ensure that commercial banks are not impeded by restrictions that reduce their ability to continue as strong, viable competitors.

However, the figures indicate that U.S. commercial banks, after losing significant market share between 1946 and 1965, have held their own since 1965. Moreover, given the present degree of leverage in their balance sheets, one might question whether a number of commercial banks could

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have easily accommodated substantial additional growth if it had been available to them.

The central point, however, is that it is not obvious that greater consolidation within the banking industry would have had a significant positive effect on the share of U.S. financial assets held by commercial banks. The biggest gains were made by the savings and loan industry, and that was largely the result of the post-war housing boom and the interest rate differential -- although in some states, branching restraints on banks were undoubtedly an important contributing factor.

2. Foreign Competition. A second, frequently-advanced argument is that greater consolidation is essential to enable U.S. banks to meet foreign competition. It is noted that in 1970 there were 6 U.S. banks in the top 20 in the world in terms of deposits, while there were only 3 in the top 20 in 1978.

A significant reason for this decline simply is the fall in the value of the dollar. The worldwide rankings are based on the dollar value of the deposits held by banks. The German mark and the Japanese yen registered substantial gains against the dollar during the period and this helped push the German and Japanese banks higher up the list. Using constant 1970 exchange rates, 5 of the 6 U.S. banks that were in the top 20 in 1970 would have been among the top 20 in the world in 1978, and the 6th would have been number 21.

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Even when properly analyzed, the significance of this statistic is not apparent. The U.S. economy is losing its dominance vis-a-vis the rest of the world; it follows that the U.S. banking system would be experiencing a parallel decline.

The issue is not whether a particular bank or group of banks appears on a list of the 20 largest banks. The real issue is whether the banking system is functioning well. Is the system sound and is it able to carry out its intermediation and payments functions? If not, would the system benefit from a substantial consolidation of firms within the American financial community? I am skeptical that weaknesses perceived by some in the performance of the banking system would be remedied by substantial consolidation.

3. Supervision and Soundness. The third argument often advanced in favor of consolidation is that it would lead to the development of a stronger banking system, easier to supervise. Larger banks, it is argued, are more diversified and have greater flexibility in terms of funding and, thus, are better able to withstand financial reverses. Supervision of a few large institutions would be easier than supervision of 15,000 banks.

These propositions have at least some surface merit. Supervision of 15,000 banks is, indeed, difficult and expensive. A certain number of problems are bound to develop each year. However, while adequate supervision of 15,000 banks is no

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easy task, one should not minimize the challenge involved in properly supervising the affairs of large banks with offices and operations throughout the world. It is not clear to me whether, on balance, it is easier to supervise 800 banks in the $25 million size range or one $20 billion bank with 800 offices scattered around the world.

Some argue that the banking crisis in the 1930s would have been less severe had there been fewer, and significantly larger, banks. Whether valid or not, development of the deposit insurance system has substantially reduced the importance of this argument. Deposit insurance provides a good deal of stability and makes the inevitable failures far more tolerable.

The Forces of Change

By now I have probably given you the impression that I am unalterably opposed to liberalization of the restraints on geographic expansion by banks. I am not. I favor liberalization of geographic restraints for several reasons -- but a desire to achieve greater consolidation within the financial services industry is not one of them.

I believe that greater ease of entry into banking and more freedom with respect to geographic expansion will bring more competitive prices and more extensive services to many local banking markets.

I believe that greater flexibility with respect to geographic expansion will be of significant value to both regional and community banks. They are being hamstrung in

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their competition with savings and loan associations and multinational banks by artificial limitations placed on their growth and development. The smaller the bank, the more effective are the restraints on expansion. The larger institutions possess greater ability to circumvent the restrictions through modern technology and devices such as Edge Act corporations, loan production offices, and so-called nonbanking affiliates.

Finally, I believe that the increasing complexity of the financial services industry requires that depository institutions be given greater freedom with respect to geographic expansion. Government social legislation -- Truth-in-Lending, the Community Reinvestment Act, the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, and the Fair Credit Reporting Act, to give just a few examples -- is burdening our smaller institutions. The Bank Holding Company Act Amendments of 1970 and the Financial Institutions Reform Act of 1978 have placed restrictions on changes in control and on the financing of bank stock, which make it more difficult for individuals to acquire and retain ownership of independent banks. The Depository Institutions Deregulation and Monetary Control Act of 1980 portends an end to interest rate controls and to mandatory specialization by depository institutions. Competition is likely to become more intense among banks and between banks and previously-specialized institutions such

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as credit unions, mutual savings banks, and savings and loan associations. Sophisticated and expensive computer and communications technology will likely play an increasingly important role in the delivery of financial services. Competition from foreign banks, which today hold over 2% of our nation's financial assets in their U.S. branches, will intensify. Competition from nondepository businesses -- such as investment banking firms, retailers, credit card companies, and the like -- will continue to grow. Finally, the economic climate has become less predictable; we are frequently confronted with conditions outside the range of our experience. Periodic bouts with inflation, which has reached intolerably high levels, have produced volatile and extraordinarily high interest rates followed by recession and high unemployment.

When these various factors are taken in combination, there can be little doubt that the environment in the financial services sector is less hospitable today than it was a decade or two ago. I have no basis for predicting that the climate will become more benign in the future.

If these trends do, in fact, continue, a number of firms may turn to mergers or acquisitions to enable them to remain strong, viable competitors. Some may seek combinations to facilitate the acquisition of management talent and expertise or to gain greater access to financial markets. Others may seek combinations to take advantage of the

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economies of scale associated with implementation of new technology and compliance with government regulations. Some may seek combinations to avert failure. Still others will choose to sell simply because the price is right. Whatever the motivation, I believe that there will be pressures in the years ahead for consolidations among our nation's 42,000 depository institutions.

Public Policy Issues

As I made clear at the outset, I am not a proponent of consolidation for the sake of consolidation. I am deeply concerned that we not permit undue concentrations of power to develop in our financial services sector.

Public policy makers, cognizant of the trends and pressures in the financial services sector, can take a number of actions to relieve undue pressures for consolidation and to ensure that the public interest will be well served by whatever consolidation does occur. I want to suggest a four-point program.

1. Reduce Small Bank Regulatory Burden. First, the regulatory burden on smaller banks can be alleviated, where appropriate, through small-bank exemptions or simpler, less-onerous versions of regulations for smaller banks.

Ideally, one would reduce the regulatory burden on all banks, regardless of size. I am directly responsible for the FDIC's ongoing efforts in this area, and I wholeheartedly support them. However, as a practical person, I recognize that there are limits to these reform efforts -- particularly

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in the absence of specific Congressional action. Thus, I see a need to focus particular attention on the problems these regulations present for smaller institutions.

Without question, the regulatory burden has a disproportionate impact on smaller banks. They often do not have ready access to trained experts on regulation, either on their staffs or in their communities. Moreover, they must amortize the cost of compliance over a comparatively small number of transactions.

The FDIC has addressed this problem by sponsoring a nationwide series of compliance seminars for banks and by amending its rulemaking procedures to require a cost/benefit analysis, and to require that we consider either a complete exemption or a simplified version for small banks, in connection with each regulation. It is not always lawful, or appropriate, to make this small-bank distinction, but where possible the FDIC intends to do so.

2. Address Disparity in Capital Ratios. A second area of concern is the disparity in capital ratios among different sizes of banks. Banks with less than $100 million in assets had equity to assets of 8.2% at year-end 1979. Banks with between $100 million and $5 billion in assets had equity to assets of 6.4%. Banks with over $5 billion in assets at year-end 1979 had an equity equal to 4.0% of assets. The point is this: whatever size categories are utilized, the percentage of equity to assets declines rather substantially in the larger banks.

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These disparities have developed for a variety of reasons. A number of arguments -- some more persuasive than others -- have been advanced to justify the present situation. It is clear, however, that as we continue our evolution to a less restrictive competitive environment, the <u>status quo</u> with respect to disparate capital ratios is becoming less and less acceptable. Smaller institutions are finding themselves increasingly disadvantaged with respect to their pricing behavior and rates of growth.

Some argue that these disparities can be eliminated over a reasonable transition period. Others contend this approach is not practical, and a better solution would be higher deposit insurance premiums for firms with lower capital ratios. Whatever the proposed solution, this issue demands our full and immediate attention as the barriers to competition between different classes of financial institutions are further eroded.

3. <u>Ease Geographic Restraints</u>. A third area of concern involves the restraints against geographic expansion. For all of the reasons expressed earlier, I believe they should be relaxed. The restraints should be liberalized gradually in a way designed to allow smaller institutions to make up some ground.

Ideally, the states will take the lead in this necessary reform effort, particularly those few states that do not have some form of statewide banking. The time has come for

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all states to give serious consideration to compacts with neighboring states to permit some form of regional, reciprocal banking.

If these reforms are not made by the states, I suspect it will only be a matter of time before the federal government intervenes. In that event, I doubt that the end product will be as satisfactory as the states themselves could fashion.

4. Reevaluate Antitrust Policy. The fourth area which requires our attention is antitrust policy. One of the unsettled issues is whether more weight should be given, in our competitive effects analysis, to the market shares held by intermediaries other than commercial banks, particularly savings and loan associations and mutual savings banks. This question will grow in importance as thrifts acquire additional bank-like powers, as they have done pursuant to the Depository Institutions Deregulation and Monetary Control Act of 1980.

A more important antitrust issue, in my judgment, is whether the laws should be amended to provide more guidance with respect to the general structure of the industry. Specifically, I am concerned about: a) the pattern of sizeable acquisitions by the largest firms in the nation or in a given region, and b) the widely divergent policies applied over time by the federal agencies, depending on the philosophies of the individuals who hold decision-making authority.

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The present antitrust laws work reasonably well when significant existing competition would be eliminated by a proposed acquisition or merger. However, they do not provide much guidance, and they have been applied in a widely disparate fashion, with respect to sizeable, market-extension mergers or acquisitions by the largest organizations.

If the present geographic restraints are liberalized substantially without addressing perceived deficiencies in our antitrust laws, I believe we will likely experience a significant increase in concentration. This is particularly disconcerting to me, because increased concentration of power in the private sector is invariably matched by increased power in the government. If a highly concentrated banking structure does evolve, the government will likely become more intimately involved in precisely how banks are operated and toward what end.

A good, recent example of this phenomenon is the bill pending in Congress under the title, "The Corporate Democracy Act". If you have not read the bill, you should. The legislation would apply to all large companies, though banks are excluded at this point. It calls for a fair degree of public intervention into matters that have traditionally been considered purely internal corporate affairs. It is said the legislation is needed because "many of the nation's large corporations are now exercising unchecked power over the political, social, and economic institutions of the country".

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If we start down this path in the financial sector -- toward greater and greater concentration of resources -- where will it lead us? Surely, reasonable but vigorous antitrust enforcement represents a sounder, less insidious public policy alternative.

Conclusion

In sum, I see no need for the revolution in the financial services industry that appears to be desired by advocates of substantially fewer and larger institutions. I am not persuaded that substantial consolidation is necessary, and my personal preference is that substantial consolidation not take place.

However, it is unrealistic to assume that some consolidation will not occur. The financial services industry is becoming more complicated and competitive, and margins are being pressured. The merger and acquisition trend will likely pick up steam as some firms seek to reap scale economies and marginal, less competitive firms are permitted to exit from the market.

But I remain steadfastly opposed to those who argue for a significant reduction in the number of firms on the strength of arguments based on size alone. The government can reduce the pressure for wholesale consolidation by relieving the regulatory burdens placed on smaller institutions and by addressing the disparity in capital ratios based on the size of the insititution. Regional and community

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banks could be assisted in their development by a gradual, well-designed easing of the barriers against geographic expansion.

In view of the evolution that is occurring in the financial services sector, a serious review of our antitrust policy should be undertaken. The review should be addressed, in part, to whether our analysis of markets and competition continues to reflect economic realities. A more profound issue is the structure of the industry that we ultimately wish to see develop. The present antitrust laws give precious little guidance on that score, and they have been used at times to permit some comparatively sizeable acquisitions by the largest banks in the nation or in a region. The full implications of this trend -- if extended -- are sobering.

We -- bankers, legislators, and regulators -- have our work cut out for us. The agenda for the future is very full.

We are a great people banded together in a strong nation. Much of our greatness and strength derives from our diversity -- our individualism. Whenever we have been confronted, though, by a clear and present challenge, we have been able to reconcile our differences and work together toward a solution that serves the best interests of our nation.

Our financial system is today faced with many challenges, and there are legitmate differences of opinion on how best

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to meet those challenges. I am confident of our ability to resolve the conflicts and tensions and to fashion a sound program for the future.

The first step in this process is acknowledgment of the legitimacy of the competing interests on all sides of the issues. We must recognize that large and small banks, and those in between, all have critically important roles to play in our financial system.

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