STATEMENT ON

CURRENT TRENDS IN THE FINANCIAL SERVICES INDUSTRY AND THEIR IMPACT ON SMALL BUSINESS FINANCING

PRESENTED TO

SUBCOMMITTEE ON TAX, ACCESS TO
EQUITY CAPITAL, AND BUSINESS OPPORTUNITIES
COMMITTEE ON SMALL BUSINESS
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Mr. Chairman, members of the Subcommittee, I am pleased to have the opportunity to testify -- on behalf of the FDIC -- on the subject of current trends in the financial services industry and their impact on small business financing.

My statement today focuses, as requested, on three areas: the dominant trend in the financial services industry--the ongoing deregulation of banking; its impact on the banking industry, the principal source of small business credit; and its ramifications for small business financing.

Bank Deregulation

Deregulation -- the term for the dismantling of the banking system constructed in the aftermath of the Great Depression -- is rapidly moving forward on an irreversible path to more competitive, less regulated financial service markets. The 1930s prohibitions and limitations on interest paid on deposit accounts basically have been completely removed; legislation separating banking from commerce while still in place is very gradually being eroded and changed; restraints on geographic bank expansion are increasingly being rendered obsolete and ineffective and are gradually being eliminated; the thrust of the 1930s legislation -- to restrain bank competition and risk-taking -- has been reversed; and the federal deposit insurance system created at that time is, as a consequence, in need of significant reform.

However, the fact that deregulation is only fully in place on the liability side of bank balance sheets greatly concerns the FDIC. Asset and geographic restraints are not in the best interests of the American public, resulting only in inequities, inefficiencies and noncompetitive markets.

Moreover, banks and other depository institutions are placed at a competitive disadvantage in the financial marketplace. Without further deregulation, bank opportunities to pursue new business and to diversify their asset risk and deposit base will continue to be quite limited, particularly for smaller institutions.

The additional risk to banks in a deregulated environment is being borne by the FDIC, in large part because the FDIC continues to operate under fifty year old constraints. Fixed deposit insurance premiums do not discourage excessive risk-taking. Moreover, the potential rewards from risk-taking accrue only to the bank stockholders' benefit while the Corporation bears final responsibility in the event of a bank failure. Fixed insurance costs also serve to penalize prudent banks since all share the cost of insurance. The FDIC insurance system probably has always provided for such perverse results, it simply was not a concern previously because of the tight restraints on competition and risk-taking.

The FDIC feels strongly that the deposit insurance system should be changed to reduce or eliminate such perverse results. Basically, the cost of insurance must be raised and/or the insurance coverage reduced. To achieve these goals, fixed insurance premiums must be eliminated and market discipline of banks must be increased. As you are aware, we have proposed such changes in HR. 5738 and in other actions.

Impact On The Banking Industry

Deregulation, in conjunction with the recent extended economic conditions of high inflation and high interest rates, is impacting the banking industry's structure and its condition.

The structural changes taking place are exactly those expected to occur in less regulated, more competitive markets. Higher rates of both industry entry and exit are being realized; the present entry rate slightly exceeds the rate of mergers, acquisitions and failures. Industry concentration too is rising as geographic banking barriers are reduced; the industry market share held by the 100 largest banking organizations has increased considerably because of the growth of regional banking organizations, not because of any growth of the ten largest organizations.

Further geographic deregulation portends substantial declines in the numbers of banks and banking organizations. In states already permitting statewide branching, the declines would be steady; in other states, the number of banks or bank organizations, or both, would decline suddenly and dramatically.

Barring Congressional action, nonbank financial and nonfinancial institution entry into banking will steadily proceed. Bank entry into nontraditional activities too shall continue through loopholes in federal laws and regulations and through individual state authorizations; further deregulation shall speed up bank product diversification and enable more efficient entry.

The banking industry's condition is being impacted principally by the recent prolonged period of high inflation and interest rates and by international economic problems. These economic conditions have resulted in major problems for many banks during the last few years. Business failures have been at or near historic peaks, losses on both domestic and foreign loans have increased as have problem loans. Banking industry earnings are down. Increased numbers of bank failures and problem banks, which are at new heights, evidence these problems. However, the industry failure rate even now is less than 0.5 percent per year, which is less than that in some other regulated financial industries and far less than that in unregulated industries.

Nevertheless, the industry is sound, failures and problem bank numbers we believe have peaked or will soon peak, and industry capital is rising. Small banks with less than $100 million in assets continue to be more profitable than larger banking organizations, although the spread is narrowing. Further deregulation should not contribute to a sudden and substantial shakeout of the industry in the future, but the numbers of failures and problem banks shall remain high relative to their levels from the 1940s to the late 1970s, when banks were highly regulated and their competition restricted.

Proposals to reform the deposit insurance system and the financial institution regulatory structure would benefit the banking community in general and the banking system in particular, but have few ramifications for small business financing. Deposit insurance reforms would redistribute insurance costs to problem banks and to banks with foreign deposits. They also would reduce the costs of the dual regulation and supervision on small banks in particular. These changes should allow most banks to more efficiently and effectively operate and compete, to the overall benefit of financial service customers.

Regulatory restructuring proposals for the uniform regulation of banks and thrifts and for the uniform functional regulation of all financial institutions would yield similar competitive benefits.

Deregulation and Small Business Financing

The best assurance that potential small business borrowers and all other borrowers have consistent access to credit on terms consistent with risk, prevailing interest rates and the overall supply and demand of savings will come from the maintenance of competitive financial services markets. The continued deregulation of banking and other depository institutions is the only way to be certain of attaining such competitive markets. Deregulation and increased competition, however, will not assure that every potential borrower receives the funds desired or the interest rate desired. Credit will be allocated efficiently and equitably on a risk-return basis.

The available evidence clearly indicates that impediments to free market behavior and thus to competition have adversely impacted consumer and small business financing. In times past, disintermediation and usury ceilings have disrupted credit flows, raised credit standards, rationed riskier customers out of the market, and made available financing even more costly and difficult to obtain. Particularly hard hit by these developments were small businesses, housing, and state and municipal financing. Deregulation of deposit interest rates and federal preemption of state usury ceilings should preclude the recurrence of these perverse results.

Deposit interest rate deregulation has substantially increased the supply of loanable funds as banks are free to compete for deposits, to reclaim market share lost to unregulated money market funds and to realize substantial inflows of "new" money. It should allow a more stable source of funds over the interest rate cycle and provide a more sound financial footing for banks, the primary institutional source of credit for small business. Access to funding should be assured at competitive market prices.

Bank product deregulation also should serve the public's best interest. Bank entry into other financial service markets and other institutions entry into bank product markets will yield considerable competitive benefits to users of financial services in particular and to the public in general.

As long as lending to such locally-limited borrowers as small businesses is as profitable as other investment alternatives, deregulation should positively impact credit flows or credit prices from the viewpoint of such borrowers. Since many large banks and other commercial and individual investors have expanded into small business loan markets during the past several years, small business lending must be quite profitable. Large banks, for example, have established small business lending units within the bank as well as outside the bank in venture capital, finance company, SBICs and MESBICs, and other subsidiary operations not restrained by geographic banking barriers. Pension funds, insurance companies and securities firms also have increased their presence in small business debt and equity markets.

Bank product deregulation in the past apparently worked to the advantage of small business borrowers, not to their detriment. Many of the justmentioned bank activities and subsidiary operations were spawned specifically to serve the financial needs of small business and other locally-limited borrowers.

In that same vein, some of the services banks now want to offer also could be very beneficial to meeting the financial needs of small business. Both equity financing and securities underwriting, for example, could well increase the supply of funds to small businesses from banks, as well as from others in the private sector, and/or reduce its cost.

Additional concerns that credit may dry up or its price increase for small businesses competing with bank subsidiaries, or that tie-ins between banks and their subsidiaries would result and adversely impact independent small businesses, are not valid concerns in competitive markets. Only in noncompetitive markets where other lenders are unavailable to eliminate the effectiveness of such tie-ins and abusive lending practices could they occur. However, since such behavior is illegal, it may not be a substantial concern even in noncompetitive markets. Nevertheless, competition is the best, most effective safeguard against such behavior.

The fact that evidence of such tie-ins and abusive lending practices is sparce also does not give credence to these concerns. Other financial institutions have been affiliated with a host of financial and nonfinancial firms for many years. Similarly, individuals have owned banks and a host of other businesses in their local communities for many years. In neither instance is there any substantial record of complaints or abuses, or that such affiliations have been harmful.

Removal of geographic restraints on bank operations offers further competitive benefits to the public in general and to the users of financial services in noncompetitive markets in particular. Through its competitive effects, geographic deregulation should have a beneficial impact on the availability of credit and its price, but not on credit allocation. Because money or credit already is extremely mobile, tending to flow to the areas or customers offering the highest returns regardless of geographic banking restrictions, further deregulation of geographic banking restraints may have little effect on where funds flow.

The concerns that geographic deregulation will necessarily disrupt or reduce credit flows to local communities and to particular classes of borrowers such as locally-limited small businesses, households and farmers, or increase the price of that credit are not well-founded. Not only are money or credit flows not significantly impacted by geographic banking restrictions in theory, but no substantive evidence is available to my knowledge that indicates that broader geographic banking authority has adversely impacted these credit flows or prices. Neither dramatic declines in the numbers of banks nor the geographic expansion of large banking organizations has had such adverse effects. Apparently as long as local credit demands by small businesses and others are as profitable as nonlocal demands, credit will be available from banks and other lenders.

The principal competitive benefits from further geographic deregulation would result from the lower barriers to entry, which appear to be a primary determinant of competitive levels of performance. With geographic deregulation, the intense competition seen in international and national loan and financial service markets should spread more rapidly to small local markets.

Conclusions

In sum, further deregulation of banking is necessary and is in the American public's best interest. Competition will increase in financial markets as existing regulatory inequities and burdens are reduced and eliminated.

The concerns raised over any negative impact of further deregulation of banking on small business financing are not warranted. As long as small business lending remains one of the most profitable investment alternatives to banks and other individual and institutional lenders, small business credit needs will continue to be met.