Remarks by K. A. Randall, Director, Federal Deposit Insurance Corporation, as a member of a panel on "At What Point Does Competition Among Financial Institutions Become Destructive?" at the afternoon session, Georgetown University Savings and Loan Forum, Hall of Nations, Edmund A. Walsh Memorial Building, Washington, D. C., December 4, 1964.

When we examine the question, "At What Point Does Competition Among Financial Institutions Become Destructive," we should first set the stage. We should ask ourselves another question: What is competition, and what is meant by destruction? And we should consider the unique circumstances surrounding the banking and other related financial industries.

What precisely do we mean by destructive competition? Are we actually asking what excesses, what aberrations in the system can lead to "destruction" or to failure?

We are here today not to come up with world-shaking and definitive answers to the questions posed to us, but to suggest some provocative and possibly fruitful lines of thought.

We might consider the possibility that competition of itself is never destructive under our existing economic system, but rather the built-in purifier which has kept the system viable, strong, and relatively lean and hungry. Ours is not a monolithic system, in which one central authority, not necessarily responsible to majority desires, makes decisions. The managed economy all too often in history has deliberately stultified competitive efforts to introduce new products, new ideas, new techniques, as being harmful to existing structures. The inflexible, unresponsive and uncompetitive economies of such states have always existed, and exist now. Historically they produce often inefficient systems administered by large and inflexible bureaucracies operating at the expense of both the prosperity and happiness of the masses.

Our system has rather been characterized by judgments of the market place -- what people will or will not accept. The result has been, on the whole, to create a society with greater mobility, greater wealth, and a more complete use of the available resources -- not to mention a spur to a greater development of new resources.

It might be suggested that competition serves to keep the system alive. At the same time it serves as the mechanism whereby decisions are rendered, as to what is to receive the available resources, and what is to cease to soak up resources, because they are unwanted, unneeded, or superceded. As an example, consider the automobile. The competitive environment of the Western World allowed the car to flourish. People wanted them, and were willing to pay for them. There was therefore a profit to be made in building cars, and many manufacturers vied for that profit. In competing for the market, they improved the product. New industries were created, and new wealth generated. There were some losses -- buggy makers, for example, went out of business.

Perhaps we are willing to concede that competition, of itself, benefits our system. But what of the proposition that competition, or any form of it, can be harmful? When we say destructive, do we mean of an industry -- of a single business -- of an individual? Do we mean a reshaping of the economy as a whole?

Consider again the development of the car. Its competitive effects were destructive -- to buggy makers. But were they, to the public as a whole? Were they, to the economy as a whole?

Perhaps we can refine our concept a bit, and say that while competition of itself may not be destructive, <u>excesses within a competitive framework</u> can be and often have been destructive to individual institutions, and harmful to industries and the general economy alike.

Before turning to considerations of ways in which competitive excesses can prove harmful to the financial community and the economy, let us first consider the unique posture that banking and related industries find themselves in, due to thier special nature.

The structure of the financial systems, and more specifically of the commercial and mutual savings banking systems and the savings and loan association system, require certain limitations upon competition, found only in a few other industries, but not to such a marked degree. Any discussion of competition within or between these three systems must consider these limitations.

Commercial banking is fundamentally different from ordinary manufacturing and mercantile businesses, in that its powers permit acceptance of demand deposits, operation of checking accounts, and lending against fractional reserves. In short, the commercial banking system has the power to create a money supply. Justice Harlan in the Philadelphia National case pointed out that for these reasons considerations other than pure competition are relevant in fixing banking within the traditional American free enterprise system.

Commercial bankers are entrusted with funds belonging to individuals and corporations, in the form of demand and savings deposits. Unlike investors these people and firms do not regard these funds as being risk capital, nor do they consider them subject to loss. Where demand deposits are involved, they do not expect any return except service. Where savings funds are concerned, they expect an earnings increment, but they forego any possible increment of capital itself.

The depositor-creditor relationship existing between customers and commercial and mutual savings banks is a unique one. In theory and law, funds placed in savings and loan associations are true investments, conferring ownership or a portion of ownership in the institution upon the investor. In reality, however, the public, and legislative authorities, look upon the relationship as being quite similar to that governing bank savings activities. While the technique and the legal status of savings and loan-investor relationships differ from that of banking, the public does not draw the distinction, with the result that in many ways savings and loans are subjected to the same competitive restrictions as banks.

Competition, therefore, cannot be allowed or imposed upon the banking system in the manner permitted other industries. Successful banking is not only the interest of stockholders, managerial talent, or employees, but most vitally the concern of the community served and the depositors in a financial institution. As a result, the maximization of profits plays only a small part in banking philosophy.

Applying these considerations, we can examine at least five ways in which competition is regulated, for banks and for savings and loan associations, to a greater degree than for other businesses. Among these are limitations on entry into the business and establishment of branches; the superimposition of diversified and careful supervision on both state and federal levels; restrictions on the types of business which may be carried out, eliminating from the financial industry much of the right to diversify, so much beloved these days by business; some control over the amount which may be paid to acquire funds, and control over the charges which may be levied for use of those funds, and finally the basic philosophy which seeks as far as possible to prevent failure of financial institutions.

The concept of limited entry plays a key role in banking. This was not always so. The American banking system has gone through three basic phases. The first was exemplified by the first and second Banks of the United States, with national charters and state charters granted solely by act of Congress or state legislatures. The second step was a reaction to this relatively monopolistic practice, so subject to abuses of privilege. New York in 1838 enacted a "free" banking law, permitting entry into banking by anyone who desired it, under certain specified conditions. This philosophy spread throughout the nation, and, as you all know, led to some grave excesses.

The third step led to controlled entry, on a basis that charters would be granted to any group, provided certain statutory criteria were fulfilled and provided state and/or national authorities could be persuaded. As of this time, "need" became a major criterion.

Thus, for the first time, it had to be demonstrated that a need actually existed -- although there were, and still are, conflicting opinions as to what constitutes need.

An additional factor in this push for limited entry was in the desire to preserve control over financial institutions as far as was possible in the local area. Rather than a system of large national financial institutions, this nation has preferred a structural system which assures local control and ownership of its financial structure as far as possible, consistent with profitable operation and satisfaction of all legitimate credit needs.

The basic thesis behind the over-all entry restriction, therefore, is that a need must be demonstrated, that local controls and local service must be emphasized, and that the operation should be profitable enough to assure its continued existance, even if in many instances this means setting up a small monopoly, as it does in hundreds of small towns and villages.

It would be helpful if we could devise a formula which could control the entry of new units, branch or originally chartered institutions, into the banking business. If some formula could be devised whereby it would be held that X number of banks, Y number of savings and loan associations, and Z number of credit unions were the proper balance for each 10,000 of population, our problems would be greatly simplified. Unfortunately, no statistical tools exist to make such formulations accurate, nor am I sure that such tools are desirable. We must still turn to factors of need, of convenience, of the dispersion, or compaction, of the population, for these decisions.

Another part of this drive for limited competition between banks and other financial institutions lies in the careful and detailed supervision by state and federal regulatory bodies. Its restrictiveness is well known to all of you, and in our limited time here we cannot consider the many ramifications of bank supervision and their impact on competition. We are all aware of the efforts of supervisors to maintain standards in loan activity, investment portfolios, liquidity, capital ratios, and management capability.

But perhaps I might offer another thought for consideration. The supervisory structure, with its diversity, and its split between state and federal authority, is in itself a different form of competition for the financial industry. If financial institutions in this country are forbidden some competitive advantages offered to most businesses perhaps the diversity existing in the present supervisory structure acts as a replacement for the diversity sacrificed. The interaction of ideas, philosophies, and operating rules and regulations, the myriad approaches by state and federal authorities, acts as a cross-pollinization which in part at least substitutes for the circumscribed situation of the financial industry itself.

Banks, both commercial and mutual, and savings and loan associations, all are limited rather tightly as to the fields of endeavor. Savings and loan associations essentially are in the dual business of accepting thrift investments and placing them in the shelter sector of the economy. Banks act as depositories, investment media, and credit grantors. Every effort has been made to isolate banks and savings and loan associations from the shocks possible in economic areas outside of the very specialized concerns of the financial institutions.

State and Federal laws control rather tightly the charges which banks may levy and the cost they may incur for funds. Federal regulations matched by some states, restrict the amounts which may be paid for time and savings deposits, and there is an absolute prohibition against the payment of interest on demand deposits. While savings and loan associations do not face any such direct prohibitions, its supervisory bodies have not been afraid to use all possible powers of persuasion to hold rates down when considered desirable.

Additionally, there are laws on the books of all the states setting forth limits on what may be charged for loans.

These so-called "usury" laws prevent absolute maximization of profits -- and have the effect of keeping banks and savings and loans from operations in more riskier areas.

Reserve requirements impose somewhat similar safeguards, and are unique to the financial community.

All of these restrictions are part and parcel of the last limitation -- the limitation against the competitive right of banking institutions to fail. This is, under our free enterprise system, a "right". Any business can in competition reap the benefits of success, or as a corollary suffer the consequences of failure. Not so banking. Banks do fail, but it is despite all efforts of the system to keep them alive. Above all, everything in the system is structured as far as possible to assure that ownership or reserves bear the loss, not the depositors. Competitive excesses become dangerous when they erode into depositor or share account funds. The very creation of the Federal Deposit Insurance Corporation was designed to preserve the nation's money supply as evidenced by depositor holdings. A parallel protection was given share accounts on the creation of Federal Savings and Loan Insurance Corporation.

Competition itself can be said to be the essential feature of our economic system. Competition within the financial system is severely limited. Nevertheless it is true that excesses do exist. It is necessary for the industry, and for supervisors, to understand what these excesses are.

We do not have the time for careful considerations of the areas in which excesses can be found, nor to analyse what might constitute destructive excesses. They may be these: limitations on destruction of economic units; constriction of economic output; misallocations of resources.

Perhaps competition can be held to be destructive when it splits up a market among units which are too small to efficiently utilize the available resources, and to offer real service to the public. If too many institutions are formed in an attempt to compete for a market of fixed size and predictable and limited growth, then service by these units may be hampered by cutting the pie into non-economic slices. For example, an area may be able to support a $3 million bank, and that bank may be able to render real and efficient service to its community. Yet two banks with footings of $1.5 million would find that too much is being allocated to expenses, that earnings are hard to come by, and that the small size made it impossible for the banks to render real and effective service to the community. In such a situation competitive pressures could actually lessen the effectiveness of the banking structure. This situation could actually stultify the economy in general, and reduce the banks' ability to support their area. We cannot draw a precise point below which banks are uneconomic. For New York City the figure would tend to be far higher than for a small town. Yet this division of markets into possibly non-economic segments can be a competitive problem of large importance. This is a broad area but it is worthy of serious study.

In a simpler vein, however, perhaps we can indicate some areas where excesses occur, and in which vigilance must always be maintained. I might suggest that many of what we call excesses in competition stem not from any basic flaws within the system, but from flaws within those people who manage the system. In other words, many of the excesses we encounter are man-made, characterized all too often either by a too-eager desire to surpass all competitors, or from a willingness to gamble on the future. We can cite several examples.

Competition in seeking funds for investment purposes has at times been destructive not only of individual institutions but almost of the system as a whole. The best known example of that is the excessive payments made during the 1920's for demand deposit funds. We have seen some banks destroyed this year when their managers sought funds for investment through payment of bounties for certificates of deposit, over the full legal limit of allowable interest. The dangers here are two-fold: not only does this action attract the least stable type of money, but in order to meet the cost of these funds, high risk loans have to be made. Several of the banks which failed this year did so precisely because managers made risky loans for high rates of interest, only to see the loans turn bad and wipe out capital.

A second danger, closely allied to the first, lies in lending activity outside the institution's area or its zone of competence. The bank that goes out of its area, where it is qualified to make credit judgments and to supervise its loans, opens the door to loss.

Too many banks seek, for competitive reasons, to enter fields in which they do not have any competence. There are times when such expansion into new fields can be supported, but only if the institution secures competence in the field.

Too many managers, especially in boom times, make loans on inflated values, or assess values not on current standards but on anticipation. Projections of the future are of value, and there are times when we must invest in the future --but financial institutions should not gamble on the future. That is the job of risk capital.

Branching excesses have proven at times to be harmful. I suspect that this is not yet a danger to the nation as a whole. The number of banking units today is approximately the same on a per capita basis as in 1940, one for each 7,000 population. Excesses in branching and in chartering of new institutions have, however, developed in some areas. Many of these new units have been opened because of future expectations that an area will in time need banking services. The paramount criterion for entry is supposed to be "need," and that supposes current need, not future expections.

In general, competition is a healthy method for assuring that our banking system will continue to serve the public with as little cost as possible. It assures that banking and other financial systems will fill the credit and thrift needs of the public. It assures also that financial systems will extend their services when the public needs them.

Excesses creep into the system when managers allow a desire for size to overwhelm their own good judgment. Excesses creep in when managers start to "bank on the future." The financial system is not a risk-oriented business; and gambling on the uncertainties of the future presupposes a strong element of risk. There is a proper place for risk investment, but the financial system is not that place.

The entire financial system is sheltered to a high degree, precisely because of the unique position of trust under which it operates. Nevertheless, excesses in competition can and do exist, and it is these which must be guarded against. This nation cannot afford a rise in competition to the point that weak financial institutions fail. The character of our financial system does not permit that type of untrammelled competition. As was proven in the 1930's, when weak institutions fail, the system fails, and that is a failure the nation cannot tolerate.