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RESTRUCTURING THE BANKING INDUSTRY: IS THERE A NEED

Remarks by

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INTRODUCTION

It is a pleasure to be here today to speak to you. I would like to spend a few minutes discussing the future structure of the banking system. Many people appear to believe that recent and prospective technological and financial developments inevitably will result in major banking structure changes with more financial services provided by nonbanks such as stockbrokers, retailers, credit card companies and others. Most often the forecasted change is the evolution to a system composed of fewer, much larger, and more diversified banks. Pushed to its limit, this view of the future would yield a banking system more along European lines--a small number of extremely large banks producing all possible financial services.

I think that you will find that many of my views on this subject differ from the scenario that is often predicted in the press. I would suggest that there is less of a financial or technological imperative for any such complete restructuring of the banking system.

FACTORS CITED AS CATALYSTS OF RESTRUCTURING

Let me discuss some of the forces that are commonly cited as causes of an imminent restructuring of the banking system. The possible causes of restructuring include changes in the Glass-Steagall Act, the removal of Regulation Q ceilings on deposit interest rates, the expansion of thrift industry powers, the current crisis in the thrift industry, economies of scale in commercial banking, and, most important, the introduction of interstate banking. In each case, I will emphasize why the particular factor does not necessarily require a complete restructuring of the banking industry.

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The Glass-Steagall Act

Would a relaxation of Glass-Steagall restraints on bank securities activities or greater product diversification by banks and bank holding companies dictate a restructuring of the industry? Looking first at securities activities, we find that before Glass-Steagall very few banks engaged in any extensive underwriting activity. No one ever cited an inability to underwrite securities as a great competitive handicap of the smaller banks. A change in the restrictions on securities underwriting by banks would permit smaller banks to underwrite revenue bonds issued by municipalities in their markets. For the vast majority of the nation's banks, this would be the limit of their underwriting activities. The smaller banks would not suffer from being unable to bid for major securities issues because their customers--consumers and small business firms--are not issuing securities.

The underwriting and sale of money market mutual funds is another Glass-Steagall issue of concern to many banks. Time will defuse this issue as Regulation Q ceilings are gradually removed. In addition, new instruments developed by the DIDC will enable the banks to compete more effectively with the money market funds. No restructuring appears necessary or inevitable on this score.

The provision of added financial services is a second part of the issue of expanding bank powers. Greater diversification is frequently cited by the banks as being necessary to their survival and as a force for restructuring. Two points should be made here. First, many services that cannot be produced economically by small banks can be distributed by outside vendors through small banks. Travelers checks and credit cards are good examples. If one had looked at the concept of travelers checks years ago, a reasonable conclusion would have

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been that banks would have to grow very large in order to achieve the national and international reputation necessary to gain widespread acceptance of their checks. Yet, the structure has not changed. There are a few providers of checks, but the vast majority of banks are distributors. While there are only a few brands of checks, there has been new entry into the business and it has become highly competitive. The inability to offer its own brand of travelers checks has not handicapped the community bank. A parallel argument could be made for bank credit cards. Now we see the beginnings of shared automated teller machine systems bringing the benefits of branch networks to smaller banks.

While many new technological developments require sophisticated data processing systems, outside vendors will provide these services to most banks. In addition, many small banks will continue to obtain payments services from the Federal Reserve banks.

Second, diversification of services is not always the route to profitability. Business history is replete with examples of conglomerate diversification attempts that led to disasters. The empirical evidence indicates many consumer finance companies and mortgage banking companies owned by bank holding companies have been less profitable than independent firms. Bill Ford, the President of the Atlanta Federal Reserve Bank, points out that the banks have been more profitable than the financial and nonfinancial firms that are attempting to provide bank-type services. While most money market mutual funds have been profitable, the other nonbank financial conglomerates have yet to establish a record of profitability.

The bottom line is that neither the continuation nor the modification of Glass-Steagall provisions should, by themselves, cause any fundamental change in the structure of the commercial banking industry. Of course, there may be

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other grounds for advocating or arguing against changes in the Glass-Steagall Act, even though its restructuring effects may not be important.

Removing Regulation Q

A second possible source of restructuring is the removal of Regulation Q ceilings on deposit interest rates. The forces pressing for interest rate deregulation are so strong that the move towards deregulation would even survive a wave of financial institution failures. Although we find no need for deregulation to cause failures, let's examine a possible disaster scenario. One could imagine a case in which the large urban banks, having access to greater lending and investment opportunities, would be able to attract deposits away from smaller, locally limited banks. The facts, however, suggest otherwise. The rate of return on assets is consistently higher at small banks than at large banks. Even when small banks are compared with large banks in the same metropolitan area, the small banks have a higher rate of return on assets. Thus, the small banks have had the ability to earn sufficient income to be able to compete for deposits.

Small banks will, of course, have to price their products and deposit instruments taking into account large bank competition. Technological change and increased consumer sophistication will bring national money market rates into every banking market and make each banker more vulnerable to deposit outflows if competitive rates are not offered. While it may be more difficult in the future, there is no evidence to suggest that the small banks cannot earn a return on assets adequate to pay competitive rates on deposits.

The Expansion of Thrift Industry Powers

Turning to a third point, one frequently hears that there are too many financial institutions in this country. The impression is given that somehow the 40,000 plus commercial banks, mutual savings banks, savings and loan associations

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and credit unions cannot all survive. Granting commercial bank powers to the thrifts adds to the intuitive appeal of this argument. Yet, is this a correct argument? If the market can support 40,000 institutions before the expansion of powers, is there any reason that it couldn't support the same number after the deregulation of thrift powers? The number of users of financial services wouldn't change and the total credit demands of those users wouldn't change. The only thing that would change is the division of the total credit demand amongst the suppliers.

The introduction of NOW accounts and share draft accounts increased the number of competitors in the provision of third party payment services, but that added competition has not been blamed for any financial institution's failure. So, the extension of bank powers to other institutions does not mean that there must be fewer institutions.

The Thrift Industry Crisis

Will the current difficulties of the thrift industry be a catalyst for the restructuring of the commercial banking industry? Clearly, the financial problems of the thrifts are resulting in a major restructuring of that industry. Supervisory mergers have eliminated many thrifts and have even produced a few interstate thrift institutions. You may have read that the Federal Home Loan Bank Board recently decided to allow a District of Columbia savings and loan association to acquire a troubled association in Virginia. While the problems of the thrifts are causing a substantial restructuring of that industry, I am not sure that thrift restructuring will lead to a parallel restructuring of the commercial banking industry.

A number of reasons can be cited for this view. First, the vast majority of banks and thrifts are totally opposed to permitting interstate banking. Full interstate banking is still some years away, although cracks in the barriers are multiplying.

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Second, federally-chartered thrifts have been permitted to branch statewide in all states for several years. Yet, in the restricted branching states most bankers continue to oppose statewide branching. The fact that a few thrifts have out-of-state ownership should not change bankers' opinions substantially.

Third, thus far the restructuring of the thrift industry has not involved major thrift acquisitions by banks or bank holding companies. The Federal Reserve Board will consider individual applications to acquire thrifts on their merits. However, the Board has been very cautious in its evaluation of proposed thrift acquisitions. Bank holding companies have not been permitted to enter otherwise prohibited activities or markets by acquiring thrifts. In addition, we would not permit the acquisition of a thrift under conditions that would threaten the financial position of the acquiring bank holding company.

Finally, although the Administration opposes any costly bail-out plan, it seems likely that some Congressional action on an assistance plan involving low current cash outlays will minimize the extent of thrift industry restructuring. Reducing the extent of thrift restructuring would likewise reduce the pressures for a parallel restructuring of the banking industry.

Economies of Scale in Commercial Banking

Over time, the existence of economies of scale in commercial banking has probably been the most frequently cited cause of a coming restructuring of the banking industry. Each new wave of technological innovations has become grounds for predicting the doom of the small bank. Small banks were going to be too small to adopt computer technology. Now they are supposed to be too small to adapt to electronic funds transfer systems. Those who believe a bank must be extremely large to be efficient seem to keep finding new intuitive reasons for their beliefs.

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There have been many very sophisticated statistical studies of economies of scale in banking. These studies clearly indicate that relatively small institutions can survive. The optimum size of a banking office is only $10-$25 million in deposits. A bank does not have to have $10 billion of assets to be efficient; $100 million of assets appears to be a very adequate size.

The statistical studies confirm that which we can observe. Thousands of banks that are not supposed to be large enough to compete with the big banks go on competing year after year. Like Mark Twain, reports of their death are greatly exaggerated. The anecdotal evidence is replete with cases in which large banks have entered new markets and have been unable to capture any significant market shares from the small local banks. The inability of the large New York City banks to attain sizable market shares when they entered upstate New York is the most frequently cited example. In addition, the large number of unit banks in California and the relatively high rate of new bank formations in that state suggest that it's not impossible for small one-office banks to compete with the hundreds of offices of Bank of America and the other large California banks.

Interstate Banking

Finally, we have the key restructuring issue: What changes in the banking industry would result from allowing full interstate banking? The means by which some interstate operations are now conducted have been cited many times. We know there are loan production offices, offices of nonbank subsidiaries of bank holding companies and Edge Act corporations. Once again, advocates of full interstate banking have had their hopes aroused as Alaska and New York have made provisions for the entry of out-of-state bank holding companies. At the moment, Alaska allows entry from any state, Maine and New York allow entry from

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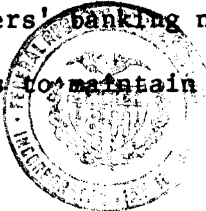
states granting reciprocal entry rights to their banks, and Delaware and South Dakota allow special purpose banks to be established by out-of-state bank holding companies. Given that no state provided for out-of-state entry from 1956 until Maine changed its law in 1975, the recent flurry of activity in this area is significant. The number of actual acquisitions that result from these legislative changes remains to be seen.

Would the general introduction of interstate banking produce a major restructuring of the banking system? The answer appears to be that interstate banking could, but doesn't have to be, the catalyst for restructuring. I would like to spend a few minutes examining the evidence on this point.

First, and most importantly, the introduction of interstate banking does not mean that small banks are doomed, although some will want to sell to large out-of-state banks. The research done by our staff does not suggest that there are any basic economic forces requiring massive consolidation. As I indicated earlier, the economies of scale argument is not substantiated by the evidence. In addition, we have noted that small banks typically earn a higher rate of return on assets than large banks.

Just as small banks can survive and compete profitably in an environment of statewide branching or statewide bank holding companies, I believe that a well managed community bank can prosper with interstate banking. Those banks that have been protected from new entry into their markets will have to sharpen their skills, control their expenses, and select those sectors of the financial marketplace they can serve most efficiently and profitably. The strongest factors they have going for them are their knowledge of their market, their customers and their customers' banking needs. They must provide those services at competitive prices so as to maintain customer loyalty in the face of new entry into the market.



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A second major issue relating to interstate banking and financial restructuring is the potential impact of expanded geographic competition on the bank failure rate. Would expanded geographic competition result in more bank failures and supervisory mergers that would restructure the system?

The general statistics on bank failures do not suggest that failure rates are any higher in statewide branching states than in states that restrict bank expansion. Expanded branching has not led to overbanking and a higher failure rate. On a more practical level, we must assume that bank expansion planners are rational, and will only open branches that have an expectation of becoming profitable after a reasonable period of operation.

In addition, the branch approval process, the acquisition of facilities and staff, and the cost of opening new branches constrain expansion. If a given branch does not become profitable, the bank can close that office, even at a loss, without threatening the survival of the bank. While the failure of a large bank is more of a shock to the financial system and more difficult for the FDIC to resolve, the large branch bank should be no more likely to fail than the small unit bank.

A third area of concern in the discussion of interstate banking involves the large bank's attention to community credit needs. Will the local branch of an out-of-state bank be responsive to the credit needs of the community? Some fear that the small town branch of the large out-of-town bank will simply siphon out deposits to its home office. The bank that does not meet local credit needs is clearly not going to be very profitable in the long run. People expect that the bank that holds their deposits is also going to meet their credit needs. If there are unmet local credit needs, other banks will be attracted into the market. Thus, the failure to lend is a policy destined to produce

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losses. While there are other factors to be considered in the debate over the merits of interstate banking, I think we have covered sufficient ground to suggest that interstate banking per se should not be an inevitable cause of a radical restructuring of the financial system.

THE DANGERS OF RESTRUCTURING

Having considered some of the suggested causes of the frequently forecasted restructuring of the banking system, I would like to turn next to the dangers of this restructuring. First, what do its proponents mean when they speak of restructuring? Basically, the term refers to a system of fewer, larger and more diversified banking institutions. Looking at these adjectives in light of the previous analysis suggests there is no technological or economic imperative requiring fewer, larger or more diversified banks. A large number of various size banks and thrifts having varying degrees of diversified or specialized activities can all coexist. Thus, a general restructuring does not appear to be required for the development of an efficient banking system.

Beyond the lack of a demonstrated case for restructuring, there exists the clear danger that restructuring would be a threat to our traditional deconcentrated competitive financial system. Restructuring, as its proponents see it, is a long process of mergers resulting in fewer and larger institutions. Are these mergers going to leave us with a less competitive banking system controlled by a small number of very large banks? While the large bank system appears to work in other countries, it is not the type of banking system traditionally favored by this country. American banking policy has always been oriented toward the decentralization of control over financial resources. I doubt that the Congress would ever accept any restructuring plan that would result in the control of the financial system by a small number of superbanks.

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Could the mergers involved in a restructuring be limited by our existing antitrust laws? Those mergers involving banks competing in the same geographic market could be blocked. The Justice Department has been very successful in preventing acquisitions involving banks in the same geographic market.

The process of forming interstate banks would, however, involve market extension mergers. In this area, the anticompetitive effects of a given merger are more difficult to demonstrate because the merging banks are not direct competitors. I would prefer to see firms enter a new market by establishing new offices, thus adding to the number of firms competing in the market. As you know, however, entry by merger is the preferred entry route.

While *de novo* entry or entry by the acquisition of a small bank are preferable from a competitive point of view, a great deal of new entry would be by the acquisition of one of the leading firms in the market. Rather than adding to the number of firms in the market, the merger merely replaces one large firm with another large firm.

Given the difficulty of applying the antitrust laws to these market extension mergers, interstate banking would most likely restructure the financial system by increasing aggregate concentration on the national level. The number of competitors in local markets might not be reduced, but over time the same few national firms would be represented in most of the major banking markets.

The likely pattern of interstate expansion has been suggested by already planned interstate mergers. For example, Trust Company of Georgia ($2.3 billion of deposits), AmSouth Bancorporation ($2.1 billion of deposits) and South Carolina National Corporation ($1.2 billion of deposits) plan to merge when the law permits interstate mergers. All of these banks rank either first or second in their states. Certainly these banks are large enough to

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capture any economies of scale that may exist; each could form its own interstate banking network. Several other examples of planned interstate mergers could be cited to demonstrate that interstate banking, once thought to involve the large acquiring the small, may involve the very large acquiring the large. This pattern of acquisitions could result in a system in which a few super large banks compete in many markets; in each market they would compete with a few small local banks that were overlooked in the merger process.

In order to prevent rising aggregate concentration as a result of interstate banking, there may be a need to control large bank acquisitions. Large banks could be prohibited from acquiring banks above a given asset size or banks having more than a certain market share. This would restrain the increase in aggregate concentration, while still allowing the large banks to expand either _de novo_ or by small acquisitions.

SUMMARY

In conclusion, this examination of restructuring suggests that we do not have to move to a system composed of a few, large diversified banks. A restructuring of the banking industry is not required by proposed Glass-Steagall changes, economies of scale, removal of Regulation Q, the problems of the thrift industry, the expansion of thrift powers or the introduction of interstate banking, although any of these factors could become a justification for restructuring.

Restructuring, required or not, could result in a substantial increase in the level of aggregate concentration of banking resources. Of course, some of this increased U.S. banking concentration, would be offset by increased competition from foreign banks and nonbank suppliers of financial services. Given the unique role of commercial banks in the financial system, however, these alternative

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sources of services may not represent an adequate substitute for a less concentrated decentralized commercial banking system. As we continue to debate the future structure of the American banking system, I hope that adequate attention will be given to the preservation of a dynamic and competitive banking system and that we will not fall victim to the idea that a big bank is, by definition, a better bank.

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