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DEREGULATION - OPPORTUNITIES AND HAZARDS
-- A CENTRAL BANKER'S PERSPECTIVE

Remarks by

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at a meeting of the

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I am happy to be with you today to discuss bank deregulation and my view of the opportunities and risks that these developments will pose for the banking industry. This subject may seem far afield from your day to day concerns and activities. But this convention strikes me as an especially appropriate forum for such discussions, because the widely dispersed credit card business--and the technological systems that support it--epitomizes one crucial element in the inexorable market pressure that is building for increased deregulation.

Technological advances in data processing and communication are rapidly breaking down all geographical barriers in the provision of financial services. Similarly, the growing capacity to handle very large numbers of relatively complex account relationships presents the opportunity of providing, cheaply and efficiently, a variety of financial services to each and every customer. When this new technical capacity is combined with the availability of high nominal returns on financial assets, as has been the case generally over the past several years, the resulting mixture produces dynamite! Normal and historic relationships quickly erode, as more and more holders of funds are prepared to jump geographic and institutional boundaries to seek out the highest bidder. Established institutions become increasingly attracted to doing new things and taking on new activities in an effort to capitalize on rapidly changing market opportunities.

In addition to the opportunities, the evolving situation contains risks--risks that must be appropriately evaluated and dealt with as banking organizations go through the sea changes in competitive conditions on which we are now embarked. Careful attention to the risks as well as the opportunities is essential not only to the welfare of individual institutions

but to the stability and soundness of the financial system on which our economy depends.

This, then, is the environment in which deregulation is proceeding. For discussion purposes, I think it useful to distinguish three major areas of bank deregulation--the removal of ceiling restrictions on deposit interest rates, the breaking down of geographic restrictions, and the expansion of activities in which banking organizations can engage. As you will see from my remarks today, the deregulation of the banking industry that we are now experiencing, and will continue to experience over the next few years, is likely to have major implications for banks and their customers.

Deregulation of Deposit Interest Rates

As you know, the Congress enacted legislation in 1980 that mandated the phasing out of Regulation Q interest rate ceilings by 1986. In order to help assure that the removal of deposit rate restrictions would not produce serious dislocations, Congress created the Depository Institutions Deregulation Committee (DIDC) to administer the phase-out. In its first year or two, the DIDC was constrained in the phase-out operation by the rising tide of interest rates and the developing thrift crisis. However, lower interest rates during the last year or so have improved conditions in the thrift industry and encouraged the DIDC to accelerate the phase-out process. Late in 1982, the DIDC permitted banks and thrifts to issue ceiling free money market deposit accounts and Super NOW accounts. Also, this summer the DIDC announced the removal, effective next month, of all rate restrictions on time deposits with maturities exceeding 31 days. After October 1, the only kinds of deposits with limits remaining will be conventional savings accounts, NOW accounts and (by law) the checking accounts of business firms.

There can be no doubt that the deregulation of deposit rates is restoring the ability of banks and thrifts to compete effectively for funds against their unregulated competitors. In just nine months time, money market deposit accounts have grown to \$370 billion. Much of this truly impressive total represents shifts of funds from other deposit forms, but a substantial amount has been diverted from the market. Money market funds, for example, have experienced a contraction of about one-third in total assets over this period, following their earlier spectacular growth. Recently, however, money market deposits at the institutions have levelled off, while money market funds have resumed a modest increase as market yields have risen. This suggests that the competitive struggle between depository institutions and the funds for the savings of consumers may have reached some sort of equilibrium.

While the deregulation of deposit rates clearly has provided a dramatic "plus" for the banking industry, it also involves some important "minuses." Undoubtedly, the major negative is the downward pressure that rate deregulation is having on net interest margins. While most institutions are feeling this downward pressure, the major impact is falling on the smaller ones, which are more dependent on the deposit sources that have been deregulated. A recent survey conducted by the American Bankers Association indicated that the net interest margins for a sample of banks with assets of \$5-25 million declined 50 basis points during the first half of 1983 compared with the year earlier period. Reporting banks with assets of \$25-100 million sustained a decline of 20 basis points over the same period.

In thinking about banking in the future, it is clear that most deposit sources will require an interest rate attuned to movements in the open market. Banks may continue to enjoy a moderate rate advantage because of their convenience and customer loyalty, but surely many

depositors will shift their funds if significant rate shortfalls vis-a-vis the market or other depositories are permitted to develop. Market rates currently are well below their highs, but considerable volatility remains and no one can say with certainty what the future may bring. Therefore, it is imperative that banks of all sizes now pay a great deal of attention to matching the rate sensitivity of their assets with that of their liabilities.

Most large banks already have developed detailed internal reporting systems that permit management to monitor their bank's interest rate sensitivity position. In addition, the federal regulators have recently implemented a new call report schedule to obtain data on the interest rate sensitivity position for all banks. The primary purpose of this report is to permit the agencies to monitor the vulnerability of individual banks to sharp changes in the level of interest rates or shifts in the shape of the yield curve, and to follow up in those cases where individual banks appear to be taking excessive interest rate risks. But this new schedule is also designed to provide each bank with the type of information needed to do its own interest rate sensitivity analysis. It is our view that the more attention individual banks pay to this matter, the less the supervisory agencies will have to become involved.

My final point on deposit rate deregulation relates to the pricing of banking services. In the past, when deposit rate restrictions prevented banks from paying a competitive return to depositors, deposit-related services were often provided at prices that did not cover costs. In an increasingly deregulated rate environment, however, banks will need to review all deposit-related services to see that their cost is fully

recovered. Net interest rate spreads are likely to be under persistent downward pressure, and I can see no other way to sustain profit margins in the new and more difficult environment.

Geographic Deregulation

The rapid changes in markets and technology that I have noted are also expanding the opportunities for provision of financial services on an interstate basis. This market reality, in turn, is bringing mounting pressures for the reduction or removal of the barriers to full interstate banking. The pressures for change arise both from within the banking industry and from the nonbank sector of the financial services industry. Nonbank financial firms, such as Merrill Lynch, Sears, Prudential, and American Express, are free to provide their expanded financial service product lines on a nationwide basis. Many thrift institutions, which used to be geographically constrained to single states like banks, are expanding interstate by the acquisition of financially distressed thrift institutions. Only full service commercial banking remains so geographically restricted.

Although interstate deposit taking banking offices are broadly prohibited under the McFadden Act and the Bank Holding Company Act, it should be recognized that many banking activities are not restricted by state boundaries. Large commercial loans have always been negotiated in a nationwide market place, and over time more and more activities are being conducted interstate. For example, the nonbank subsidiaries of bank holding companies provide mortgage banking, consumer finance, and other financial services through 5,500 offices located outside the home state of the parent companies. Edge Act corporations operate 143 offices outside their home states for the purpose of financing international trade. Altogether, including loan production offices and the offices of the grandfathered multistate bank holding companies,

there are nearly 7,400 offices that could be broadly categorized as inter-state banking offices. In a more recent development, some large banks have been shifting the servicing of their expanding nationwide credit card operations to special purpose banks located in states with high or no usury ceilings.

The McFadden Act of 1927 imposed an absolute prohibition on inter-state branch banking, but the Douglas Amendment to the Bank Holding Company Act allows the states to enact laws permitting entry by out-of-state bank holding companies. No state opted to exercise this authority for 20 years until Maine, in 1975, revised its banking code to provide that out-of-state bank holding companies could acquire or establish banks within the state, provided there were reciprocal entry rights for Maine bank holding companies. In 1982, Alaska and New York enacted out-of-state entry laws. Massachusetts, Connecticut, and Rhode Island also now have reciprocal entry statutes, but these only allow entry from other New England states--a restriction currently being challenged in the Courts.

South Dakota and Delaware allow out-of-state entry for special purpose banks, such as the credit card banks I mentioned earlier. Banks established in those states are not intended to compete with the local banks, but rather to add to the local employment and tax revenue base. In addition, Florida, Iowa, Nebraska, and Illinois allow new acquisitions by holding companies that were already operating subsidiaries in those states by 1956.

It does seem to me that the interest in expanded banking boundaries along regional lines is gaining momentum, but how quickly enabling State legislation will proceed or how widespread such arrangements will become is

hard to say. I see no serious problem with the development of regional banking. It should serve to strengthen regional banks and it seems a rather natural first step in expanding from a one-state to a multi-state banking concept.

But I do have reservations about an inter-state banking concept that is exclusively regional in character. First, there is the issue of fairness-prohibiting the entry of out of state organizations, or sales of existing banks in the target area on the most favorable terms, simply because the institution that desires to expand is not included in a regional grouping. Second, residents of some parts of the country might be denied the benefits of sharper competition and expanded services that would be expected to flow from interstate banking for a very long time if enabling legislation were to depend on the actions of each and every state. Finally, regional banking would not take full advantage of the capabilities of developing technology, and in any event would not place banks on an equal competitive footing with nationwide non-bank institutions.

Therefore, it seems to me that the time is at hand to begin liberalizing banking restrictions at the Federal level. How far such a liberalization might go, of course, will depend on the Congress and on the interplay of opposing interests in the financial services market. One good first step, however, might be to permit the interstate operation of full service automated teller machines. At present, ATMs cannot accept deposits interstate, and in many states their deployment is subject to the same constraints as brick and mortar branches. A statutory declaration that ATMs are not branches for legal purposes would open the way for state, regional and nationwide electronic branching. This change would provide a greater measure of convenience for many bank customers, especially frequent travelers.

A more sweeping but still gradualist approach might be to permit interstate banking by means of de novo entries or foothold acquisitions--restricted, say, to purchases of banks with assets under \$100 million or less than 10 per cent of the market's total deposits. This would permit the penetration of out of state banks into most markets, but not through the acquisition of such large units that existing state banking structures would be threatened, at least not initially. Or it could be that full-scale interstate banking may be authorized, subject only to restrictions that would prevent undesirable concentrations of financial resources.

Whatever the initial form, I believe that the spread of interstate banking has now become inevitable, dictated as it is by technological capability and market competition. An expansion of general interstate banking would provide new opportunities for many banks. Banks that are constrained by state laws would be able to expand into new markets--a prospect that would be especially attractive to those institutions operating in the slower growing regions of the country. And to the extent that the expanding banks would be able to compete for deposits and consumer and small business loans over a wider geographic area, the diversification of their loan portfolios would tend to improve, and hence risk exposure should be reduced. On the other hand, we have learned, again from recent experience that expansion into new areas and new lending activities requires some care, since attempts to build up market share rapidly can be quite risky.

The major risk to the banking system from geographic deregulation, however, stems from the potential that some participants would attempt to expand too greatly and bid too aggressively for new additions to their organizations. This danger seems to me especially acute for acquisitions in what are perceived as high growth areas. More generally, realistic evaluations will be difficult in a financial services market where competitive conditions are changing rapidly, where

net interest margins are under substantial and persistent downward pressure, and where historical experience will provide only imperfect guides to the future. The cost of your mistakes could be reflected in a dilution of per share earnings, in the taking on of imbedded acquisition or expansion costs that cannot be recovered, and perhaps in a generally weakened banking organization. The watchword will need to be to "take care."

Product Deregulation

Over the last several years, as you well know, an increasing number of financial firms that formerly specialized in one sector of the financial services industry have begun to diversify their operations. Savings and loan associations, having recently been granted greatly expanded powers, are now beginning to take on a number of banking functions, including active solicitation of transactions accounts, commercial credits and a broadened range of consumer financing. (Indeed, a good many seem to be adopting new names with bank in their title.) Some insurance companies have entered the securities business or set up limited purpose banks. Also, some securities firms have set up limited purpose banks or acquired savings and loan associations.

Banking organizations also have been moving into new lines of activity recently as a result of developments in the marketplace and some liberalization of the activities in which they can engage. Last year, Congress authorized export trading companies for bank holding companies, and the Federal Reserve recently has added the futures commission business, discount brokerage and the arranging of equity financing for income-producing real estate projects to the list of permissible activities under Section 4(c)(8) of the Bank Holding Company Act. We have also recommended to the Congress that banking organizations be permitted to engage in other activities now prohibited by statute. First, the Federal Reserve has long urged that banks

be allowed to underwrite municipal revenue bonds, now prohibited by Glass-Steagall. This form of underwriting is clearly within the capability of banks, and bank entry, by increasing competition in the activity, would lower the cost of financing to many state and local governments. We have also recommended that banks be allowed to sponsor stock and bond mutual funds, an activity that nicely compliments other retail banking services and represents a natural extension of similar activities that banks have long performed in their trust departments.

This summer, the Treasury Department sent to Congress an Administration bill that would greatly expand the permissible activities of bank holding companies. This proposal would permit bank holding companies to engage in most forms of non-corporate securities underwriting and dealing, insurance and real estate brokerage, insurance underwriting, real estate development on a limited basis, and other activities determined by the Federal Reserve Board to be of a financial nature. The proposal also would permit companies in the securities, insurance and real estate businesses to enter banking. Chairman Volcker testified last week for the Board on the proposed bill and gave it our general support, so long as the legislation contains certain provisions designed to maintain a sound banking system and achieve other public policy goals.

The recent expansion of permissible banking activities, and the further substantial expansion envisioned if the Treasury bill is passed, would present major opportunities to expand services and enhance earnings. Many banks would undoubtedly focus first on marketing these new services to their existing customers. In this effort, banks should have at least two advantages. First, the bank will have had a long-standing relationship with many of these customers. Second, the bank may be able to distribute

some of these services as joint products at lower costs, and hence market them at lower prices than their competitors.

While expansion into new financial activities offers opportunities, it also involves certain risks. First, if banks enter new activities through acquisition, there is the risk that they may pay too much for their acquisitions--the same danger that I noted with regard to bank acquisitions in response to geographic deregulation. Second, several of the proposed activities contained in the proposed bill involve significant new risk exposures. In my mind, the leading example is real estate development--an activity in which a lot of money can be both made and lost, and in which there is a natural tendency for entrepreneurial enthusiasm sometimes to overwhelm the objective evaluation of risk. Third, a number of activities that have recently been opened to banks, or would be by the proposed bill, are already highly competitive. One example is discount brokerage, which is now witnessing massive entry and sharp price competition. Another is property and casualty insurance underwriting, where severe price competition contributed to losses on the underwriting part of the business last year amounting to over \$10 billion. Fourth, and perhaps most important, there is the risk that some banking organizations will not exercise sufficient care when entering new activities. I would remind you of the experience of the early 1970's when some banks rushed into mortgage banking and advising REITS only to sustain sizable losses and significant damage to their reputations.

One final point with regard to expanded activities needs special emphasis. Whether expanding by the addition of new holding company activities or by acquiring new banking units in near or distant geographic regions, banking organizations will have to pay very close attention to maintaining appropriately strong capital positions. Neither the market nor the supervisory

authorities will look favorably on situations where efforts to expand the organization's reach result in an unduly high leveraging of equity. This means, in most cases, that significant expansion will need to be by means of an exchange of shares, or by a willingness and capability to tap the securities markets for new permanent equity-type funding. Retained earnings could also provide some latitude, of course, but normally retained earnings will not far exceed the additional capital needed to support internal growth of the banking organization.

Conclusion

I would like to close my talk by going back to my initial remarks. The banking industry is now experiencing significant deregulation, and further even more substantial deregulation seems likely in the next few years. This deregulation movement is the inevitable product of major advances in technology and changes in the financial services market place, and it is also consistent with the broader concept of reducing the role of government in the business sector. As the deregulation movement unfolds, it will present banking with a variety of opportunities--the opportunity to offer depositors a flexible and fully competitive rate of return, to offer a full range of financial services, and to offer banking services over a broader geographic area. Over time, these developments cannot help but make banks more effective financial intermediaries.

At the same time, deregulation is not without its hazards. The banking industry, which is already very competitive, will surely become even more so as these changes take place. This will occur not only because more banks will come into direct competition with one another, but because of the gradual homogenizing of the entire financial services industry, which will bring banks

increasingly into competition with savings and loans, investment companies, securities broker and dealers, insurance companies, and other types of financial intermediaries. This increasing competition in banking and the financial services industry is likely to put persistent downward pressure on profit margins and force all banks to adopt rigorous expense controls. It will also expose banks of all sizes to the full force of changing financial market conditions, on both the asset and liability sides of their balance sheets.

As I have spelled out in some detail, the new opportunities that banks now have or may obtain in the next few years are likely to entail some significant risks. Consequently, it is vital that banks' managements proceed to exploit these new opportunities with considerable care, giving close attention to credit risk, exposures to interest rate volatility, adequate compensation for all services rendered, and the fair but realistic pricing of new acquisitions. And with all of the risks that deregulation of a previously highly diverse and decentralized banking industry entails, it is especially important that banking organizations maintain their overall capital positions at safe and prudent levels. Given these cautions, I am confident that the period ahead can be constructive and highly rewarding, not only for banking but for the quality, convenience and economy of financial services that are provided to the American public.

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