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"Observations on Some Other Aspects of Banking Deregulation"

Remarks by

Emmett J. Rice

Member

Board of Governors of the Federal Reserve System

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As one sometimes identified as an economist, I am pleased to be invited to appear before this group of banking lawyers. I wouldn't be surprised, however, if some of you might wonder about the relevance of an economist to this, or any other, banking forum these days. I certainly have! The banking scene now often seems to be dominated by legal rather than economic or even traditional banking issues.

At the Federal Reserve we sometimes seem to be presented with as many difficult legal questions as with matters of financial policy. As a consequence, although I cannot claim to have had any legal training, I must admit to having been compelled, as a Board member, to try to think like a member of your profession from time to time. Therefore, to the extent my economic background is insufficient, I intend to rely on my modest exposure to legal issues as justification for being here.

I am aware that members of the economics profession are often criticized for giving contradictory interpretations of current developments and making widely disparate forecasts. In fact, it's been said that if all the economists were laid end to end they would still point in all directions. Some cynics have even suggested that if economists ever agree on anything, it's very likely to be wrong.

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However, there was a time -- I admit it was in my more naive days -- when I assumed that, unlike economists, when you lawyers were asked a question you responded with the same answer. After all, the law _is_ the law and you don't have to make forecasts. I have learned better. And I can give you some examples.

Our lawyers at the Federal Reserve tell me that commercial paper is a commercial loan for purposes of the Bank Holding Company Act. Those at the FDIC and the Comptroller of the Currency say it's not. The Securities Industry Association and the SEC say that commercial paper is a security for purposes of the securities laws. Our lawyers say it's not. They tell me that a N.O.W. account is a demand deposit under the Bank Holding Company Act. Our ex-general counsel, Jerry Hawke, says it's not.

And it gets even more confusing. Our lawyers say that a bank that accepts demand deposits but doesn't make commercial loans is a "non-bank bank." The Comptroller says it's a "consumer bank;" Sears says it's a "family bank."

I have thus come to appreciate that economists and lawyers have much in common. So I almost feel at home today.

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We are obviously going through a very complex period with regard to our financial institutions. We operate under laws designed to restrict interstate banking. Yet operating across state lines is a fact of life for most major banks. We have long held that the separation of banking and commerce is a bedrock principle of public policy. Yet without any Congressional decision to the contrary, that separation is rapidly blurring. The emergence of new competitors and the removal of the restrictions on paying depositors a market rate have destroyed a century of comfort in the banking industry. And there are stranger aspects to all of this. For example, we are told that in order to increase the soundness of institutions, they must be permitted to get into riskier ventures.

I do not want to dwell on these developments, since they are well known to everyone in this room. What I do want to do is discuss with you some features of the new banking scene that have the potential to produce adverse consequences to some bank customers -- both individuals and small businesses. I have in mind such things as the accelerating trend to close branches, the imposition of substantially higher fees and service charges, the shift of interest rate risk to consumers through adjustable rate mortgages,

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the developing disinclination of institutions to cash government checks for nondepositors, the widespread concentration on "upscale banking," the rush to increased reliance on technology as a means to lower costs, and the movement away from community-based institutions.

What is interesting about a list such as this is that until recently we have given very little systematic public attention either to the likelihood all of this would occur or to its implications. I don't claim to have read all of the thousands of pages of Congressional testimony delivered in recent years on our changing financial system. But based on my proximity to the process, I am confident that surprisingly little of that discussion dealt with these matters.

It seems to me that it's time to recognize the importance of looking more closely at the possible adverse effects on low- and moderate-income individuals of some of the changes taking place in our financial system. Certainly, we must continue to give careful attention to issues such as the propriety of banks and others using loopholes in our banking laws and the efforts of the agencies or the Congress to close these loopholes, as well as

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the wisdom of granting new powers and allowing full interstate banking. But in my view, there are also other aspects of this dynamic landscape that require serious examination as we try to develop the optimal system for the future.

One of the features of the current banking scene is the emphasis on "upscale" marketing. The reasons are not hard to understand. They're probably as simple as Willy Sutton's old explanation of why he robbed banks -- simply because "that's where the money is." While no one can quarrel with an institution's right to pursue that market (or any other), one has to wonder about the consequences to individual institutions, and to our banking system as a whole, if large numbers of institutions follow that approach. After all, by any measure, the "upscale" market is rather small. In terms of income, for example, our surveys suggest that half of the nation's families have incomes below $19,500, and only 10 percent have incomes of $50,000 or more. Should a great many institutions adopt the "upscale" strategy -- and succeed -- a very large segment of the Americans will have been "demarketed" -- a disturbing thought given our professed commitment to universal access to our payments system.

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Branch Closings

In a financial world driven by unbundled pricing, rising costs, unregulated aggressive competitors, and emphasis on short-term bottom line results, it is inevitable that branches, perhaps in great numbers, will be closed. We know that when institutions were prevented from paying market rates for deposits, they paid depositors in other ways -- including by building them convenient branches. To the extent that institutions must now pay what the market demands, it is unreasonable to expect that they will continue their implicit payments as well. We already have strong indication of the trend to close branches. In 1979, for each branch closed, five were opened; in 1984, for every branch closed, only about one opened, a trend that I expect will continue.

But to recognize the inevitability of branch closings does not mean that one should ignore the potential impact. Some banks may use the opportunity to weed out low-balance accounts, or to leave lower-income neighborhoods altogether. Merchants who depend on the ready availability of cash for neighborhood residents to buy their products may be hurt.

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Vacant bank buildings can be a dramatic psychological signal of loss of confidence in the community.

Of course, many of the services now performed by branches may be performed more efficiently by alternative delivery systems. However, these alternatives -- such as debit cards, home computers, POS systems, and pre-screened mail solicitations for credit, to name a few -- probably won't replace all of the traditional services. Moreover, some of these substitutes may not be available to people of low and moderate means -- home banking through computers is an obvious example. These same groups may also have more difficulty than most with "high tech" ways of getting bank services because of problems of low literacy and unfamiliarity with technology. At the same time, many of these people have come to expect they will be included in the nation's payments system. And it's not very difficult to imagine the very substantial political issue that could develop if they are excluded in large numbers.

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Deposit Accounts

Another aspect of the changes going on in the system are the increases in service charges and fees on accounts. Our studies have shown that the increases have been two to four times the increase in the general price level from 1980 to 1983, although bank expenses for personal checking accounts increased even more rapidly than did service fee income. There is some evidence that certain groups may not be using the banking system as much as they once did. For example, the number of younger people with checking accounts went down significantly from 73% to 63% between 1977 and 1983 -- perhaps, although we don't know for sure, at least partially because of these increased fees. In the lowest income category, regardless of age, the drop was from 56% to 44%. The figures also suggest that the number of young families with neither a checking nor savings account doubled (from 11% to 22%) between 1977 and 1983.

One cannot help being somewhat concerned with figures like these if they, in fact, suggest that lower income and younger consumers are being adversely affected by what's going on in our financial system. For generations,

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we have encouraged thrift among the young, not only for its own sake but because we believed it taught general financial responsibility. If that thrift is being discouraged on a wide-scale basis, the implications could be far reaching.

Lack of a deposit account can have other adverse consequences. For example, it can make it even more difficult for low income people to obtain credit. Often, credit availability is tied to having an account relationship. Similarly, an institution's willingness to cash government checks is frequently tied to the recipient's having an account.

Cashing Government Checks

This latter point provides an example of a public issue that probably needs further attention. For years, banks have assisted local residents and governmental programs by cashing government checks, often for depositors and non-depositors alike, and typically without charge. Many did so with reluctance, however, given such inconvenient aspects of the programs as the bunching of payments at particular times during the month, and the right of the Federal

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government to charge back a check to the institution many years after it was cashed.

Given the new cost pressures, many institutions -- quite understandably -- are apparently rethinking this accommodation. Some of them now restrict service to those maintaining accounts, accounts that are, of course, no longer "free." Alternatively, institutions may seek to recoup some of their own costs through charges to the check presenter, who frequently is low-income.

Here again there seems to be a developing public issue. The American Association of Retired Persons, for example, reports increased concern among its members about these practices. Several states are considering bills to compel institutions to cash government checks.

The solution to the problem is by no means clear. Nor is it obvious that the banking system itself should bear the cost of subsidizing low- and moderate-income groups and small businesses in the provision of banking services if that's what's needed. I was for some time a commercial banker myself, and were I still in that business I would doubtless respond to market pressures,

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hopefully ahead of the competition. What does seem clear is that these issues have potential implications for substantial numbers of people, and probably deserve some serious consideration in the debate about the future rights and responsibilities of the industry and government.

The Role of Lawyers

Now why am I talking to you about all this? What can bank lawyers do in this arena? My lawyer colleagues at the Board tell me that some guidance is suggested in the Model Rules of Professional Conduct, which identify a broad role for attorneys in advising clients. According to those rules, "in rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation." To the extent that you can assist your banking clients in not overlooking the social consequences of their actions in the new environment, you will have performed an important public service. Woodrow Wilson (who, incidentally, eventually abandoned the legal profession) probably said it best when he suggested that "the first duty of law is to keep sound the society it serves."

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Moreover, I hope I'm not presumptuous in suggesting that keeping in mind the social impact of the law can make good business sense as well. One can only speculate that the attorneys who advised some banks about currency reporting requirements may have approached those regulations as simply one more set of burdensome governmental rules. Had they been more sensitive to the social concerns underlying the rules, their banking clients might not have taken them so lightly, to their ultimate embarrassment.

I am not suggesting that you counsel institutions to subsidize low balance depositors, necessarily. Nor am I advising you to counsel them to pull back from an economic analysis of the profitability of branches. I am suggesting that the possible negative implications from the changes going on should not be overlooked, and that you explore creative possibilities for maintaining "basic banking" services to as broad a segment of the public as possible. You can help clients recognize that the single-minded pursuit of the "up-scale" market, and efforts to "demarket" small-balance consumers, may have adverse consequences both politically to the banking system and more fundamentally to the nation, unless coupled with efforts to ameliorate the impact.

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You can encourage experimentation and research into how the needs of young and lower income people can be served in this changing environment. You can make sure that the implications of branch closings are well thought out -- for example, by insuring that consideration is given to alternative ways of delivering services, rather than just having the institution walk away from a neighborhood.

And you can keep a sharp eye out for the kind of overreaching that can worsen the situation. For example, you might counsel against uncapped ARMs, or those with deep discounts where borrowers are qualified at the discount rate based on unreasonable assumptions about future income growth. You can be alert to deposit rate advertising that doesn't fairly give the full story, or to unreasonable government check cashing policies, or to delayed funds policies where the holds on checks exceed the real risk to the institution.

No one can reasonably expect that there won't be dramatic changes in our banking system. And it's probably unrealistic to expect that no one will suffer inconvenience, or worse -- particularly during the transition period.

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But as we struggle through this turbulent period, it does seem reasonable to expect that we all -- bankers, their legal advisers and government bodies -- will be sensitive enough, and far thinking enough, to anticipate the potential adverse consequences to small users of financial services, and then do our best to minimize those consequences.

Your profession has traditionally attracted some of the best and brightest, and you have great influence. I would like to hope that, as you advise clients about how best to chart their course through this difficult period, you keep in mind the need to seek ways to preserve access to the banking system for all citizens.

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