Implications of Banking Deregulation

Remarks of
Robert P. Forrestal
President
Federal Reserve Bank of Atlanta
to the
Atlanta Group
Robert Morris Associates
Atlanta, Georgia
July 24, 1984

The Robert Morris Associates have a long and distinguished record of service to banking, and it is an honor for me to be invited to share with you some thoughts about recent regulatory and financial structure changes that have profound implications for the banking profession.

We understand that Atlanta will soon become the site of RMA's first regional office, and it will be a genuine pleasure to welcome that office to Atlanta and to help it, if we may, to accomplish its mission.

It is people like yourselves who will be involved in making the important adjustments during this period of transition.

Personally, I'm persuaded that the users of banking services will benefit from these changes. As for banks, however, there will be winners and losers. The winners will be the innovative and efficient ones. Incidentally, some of the winners won't even be banks; they'll be the nondepository institutions like Sears Roebuck and Merrill Lynch — firms that have already convincingly demonstrated their ability to move into the banks' turf through the "nonbank bank" route. With all its hazards, however, the new environment holds many opportunities, and it has always been my experience that the alert and imaginative bankers invariably know what to do with opportunities.

Recently, three primary groups of regulations have been in the process of change. Those three groups are deposit interest rate, geographic, and activity (or product) regulations. They are all being relaxed or, perhaps more important, side-stepped through innovation. I would like to discuss the demise of each of these groups of regulations and to tell you what I believe are some of the implications.

<u>Interest Rate Deregulation: More Competition, Sharper Pencils</u>

Let's begin with deposit interest rate degregulation. All interest rate regulation on banks and thrifts is gone except the zero interest limit on demand deposits and the low interest rate limits on NOW accounts and savings deposits.

I can recall the time not long ago when some corporate treasurers and others who had funds to manage simply placed those funds with conveniently located banks in either demand deposits or low yielding time deposits. Because of interest rate ceilings, there was little or no rate competition for the funds. There were almost no monetary incentives for those money managers to consider anything other than availability and proper security. With the ceilings largely gone, increases in the level of interest rates and the development of alternative instruments and markets have caused money management to become a sophisticated, big-ticket operation. The money manager is now a recognized, professional specialist practicing an art that has nearly become a science.

Elimination of deposit interest rate ceilings has induced many banks to unbundle their services. They can analyze their operations carefully and charge fees for services that were formerly paid for with balances. Like most business customers, money managers welcome the substitution of fees for balances. However, these money managers may have found sharper analysis of the advantages of all of today's options more than a bit challenging.

Get ready for a further jolt. The move to strip interest rate ceilings from transactions deposits has been only temporarily arrested by current uneasiness about the banking system. It seems likely to me that this move will bear fruit within the next couple of years. Banks' and thrifts' interest margins may be squeezed again. This could lead to further impositions of fees for services rendered as banks make another round of adjustments in an effort to make unprofitable accounts profitable again.

Geographic Deregulation: It's Already Here

Now, let's turn to geographic deregulation, which is currently a particularly hot issue in the Southeast. From the public's point of view, national interstate banking seems desirable. In any event, it seems inevitable somewhere down the road. In the meantime, however, adjoining states are beginning to develop agreements that establish regional interstate banking. As you know, four of our southeastern states have passed regional interstate banking laws: Florida, Georgia, North Carolina and South Carolina.

The first point that I want to make about interstate banking is that it already has become quite prevalent in many places. Florida is a leader in interstate banking. The Sunshine State has more than 375 offices of out-of-state bank holding companies offering almost all bank services except on-site deposit-taking offices. NCNB Corporation (of North Carolina) and Northern Trust Company (of Illinois) operate more than 135 offices in the state.

Now that NCNB has acquired Ellis Banking Corporation, it is Florida's fourth largest bank.

Edge Act corporations and offices of foreign banks with multistate operations add 53 offices to the total of offices of out-of-state banks. Eight of the nation's largest thrift institutions operate in Florida with offices that offer many banking services. Citicorp has recently added a large Florida thrift to its already extensive Florida operations. All told, more than 500 offices of out-of-state banks, bank holding companies and thrift institutions operate in Florida.

Interstate banking is not so prevalent in the other southeastern states. But, each has some offices of out-of-state banks, ranging from 3 in Arkansas to 370 in North Carolina in a count that we did about a year and a half ago.

There is nothing in the cards that seems likely to wipe out existing interstate banking. Indeed, there are new breaches of the barriers separating the states almost every day, the most visible from our southeastern perspective being the recent announcement from the Trust Company of Georgia and Sun Banks of Florida of their intention to merge. Unless the courts forbid it, U.S. Trust Corporation of New York will convert its Miami trust office into an FDIC-insured bank which will take all kinds of deposits and make consumer loans. This could be the beginning of a new and significant phase in the advance of interstate banking. The Comptroller of the Currency has committed to approving hundreds of such interstate expansions unless Congress forbids it by September 1 of this year. These developments, I should point out, are being carried out under the Bank Holding Company Act with the sometimes grudging approval of the Federal Reserve Board.

In part because of the market forces generated by existing interstate banking, several states have already taken it upon themselves to pass interstate banking laws before the Congress decides what is to be done on a national scale. So far, 20 states have some sort of interstate banking laws. They range from that of Maine, which allows unlimited out-of-state holding company acquisitions, to that of Iowa which allows a specific "grandfathered" company to make acquisitions.

Seven states have now enacted regional, reciprocal banking laws. The Board of Governors of the Federal Reserve System eliminated much of the uncertainty about whether it would allow bank holding companies to take advantage of these regional interstate banking laws in late March by approving two interstate acquisitions under such laws in New England. A lower court has passed on one of these acquisitions; a federal appeals court has stayed consummation of these acquisitions pending its decision on the case. That decision is due any day now.

Georgia, Florida and the Carolinas are among the latest states to enact regional reciprocal laws. As you are well aware, these recently enacted statutes allow bank holding companies from other southeastern states which pass similar laws to acquire banks in the enacting states. Whatever the status of regional and national laws at this point, there is also the issue of "nonbank banks." Unless

Congress acts to curb their growth, these institutions may in time provide financial services all across the nation. The fine line that separates their activities from those of banks may become impossible to distinguish. In terms of their range of activities, in fact, they have broader powers than banks. However, the market forces that have already led to the de facto interstate moves of both banks and "nonbank banks" are still at work, and it is probably only a matter of time before the remaining legal barriers to nationwide interstate banking crumble away altogether.

Competition: Probable Benefits Exceed Probable Costs

How will interstate banking affect competition? That's certainly a question that has been subject to a good deal of debate.

Most of the debate about interstate banking assumes (correctly, I think) that larger banks will cross state lines with acquisitions and that unacquired smaller banks and bank holding companies will have to compete with larger banks than they do now. Consequently, most of the evidence on benefits and costs of interstate banking comes from studies of differences between large and small banks.

What do we know about competition between large and small banks?

1. A large body of research on costs of producing basic banking services—DDA, savings and time accounts, consumer and commercial loans and investments—has concluded that larger banks have no production cost advantages over small ones. The evidence indicates that banks of about $100 million in asset size produce basic banking services most efficiently. Banks smaller than these may have substantial cost disadvantages; larger banks' cost disadvantages are slight.

2. Other studies of larger banks' performance when they enter new markets strongly suggest that they do not seriously harm other banks or take away their market share. This has held true

whether the larger banks entered with new operations or acquired foothold banks or acquired dominant banks.

Even the large New York City banks have had a very difficult time gaining market share in upstate New York since they entered markets there in the early 1970s. By 1980, their average market share gain in metropolitan areas was 1.3 percentage points. Spot checks of 1982 branch data indicate that they are still making few, if any, gains.

Large bank holding companies in the Southeast have had no better records. Their de novo banks have done no better than independent de novo banks in the same markets. When they have acquired banks with large market shares, they typically have lost market share in the aftermath.

3. Future introduction of computer techniques with substantial economies of scale are not likely to harm small banks' competitive position against large banks. The new technology is

divisible. There will be numerous service companies, franchisers, correspondents and cooperatives willing and able to run large service operations and sell services to small banks. Small banks may even have an advantage in this because they can avoid major capital investments. That will allow them the flexibility to adopt new techniques as they appear.

4. The threat of large banks gobbling up all other banks and establishing a noncompetitive financial structure is further mitigated by their present capital positions. Most of our country's largest banks have capital-asset ratios which are close to their regulatory minimum. The present mood of the regulatory agencies suggests they will, if anything, increase capital requirements. Most money center banks will have limited capacity for interstate expansion with current capital. To expand they would have to go to the market for new capital.

5. Large banks are able to offer some sophisticated services that small ones cannot offer competitively. They may be franchised

to smaller institutions, however, in much the same way that travelers' checks have been. Entry of larger banks may add convenience and flexibility for some customers who use those sophisticated services.

Together, all these facts suggest that interstate banking does not necessarily pose a threat to smaller bank holding companies and independent banks. Nor does it seriously threaten to raise local market concentration. Smaller holding companies and banks are likely to survive if their managers are sharp and they plan ahead. They will have to adapt to geographic deregulation, just as most have successfully adapted to deposit interest rate deregulation. The evidence from academic studies of costs and from market experience indicates that they can.

If anything, the evidence suggests there will be more competition for the business of those who have money to manage. More competitors will enter some areas where profit opportunities are greatest. In all areas, bankers will have to be more wary of new competitors "waiting in the wings" for a local bank to make a mistake. Typically, new entrants are more competitive than old ones, because they have to draw customers away from the old ones. This may improve the quality and decrease the prices of some financial services. It should also tend to increase the rates paid for deposits.

We tend to think in terms of a smaller bank either being gobbled up by a larger one or surviving as an independent, but there is another possibility: We may see new "federated" management of chains of community banks and other small financial institutions, each with a great deal of local autonomy, regardless of ownership.

The Federal Reserve will, of course, continue to analyze competitive effects of acquisitions and to deny acquisitions that have seriously adverse effects, but we are not particularly concerned that interstate banking will make this job more difficult.

Certainly some banks will accept offers that they cannot refuse from out-of-state acquirers. We will end up with fewer banks than the 14,000 or so independent banking organizations that we have now. Banking concentration in the nation will increase but there is no reason to believe that the increase will be sufficient to cause a threat to the public. More than enough banks will remain to discipline any bank that tries to exploit a concentrated position by charging higher prices, skimping on quality or paying too little for deposits. The concentration of banking in the United States is among the lowest, if not the lowest, of the developed countries. Moreover, our banking markets are open to foreign competitors, as well. It is highly unlikely that we will see great concentration. In fact, we may even have too many banks.

Bank Safety: No Threat from Interstate Banking

Some observers have been wondering whether interstate banking poses a threat to bank safety. By now, you have probably gathered from my remarks that we do not expect to see it causing an epidemic of trouble among small banks. Previous changes from unit banking or local branching to statewide holding companies or branching have not had that effect, even in New York.

There are three other "safety and soundness" effects that interstate banking may have, however. Two of these decrease our concerns about safety, but one does give us some problems. First the good news. Opening up state lines will make it easier for regulators to find merger partners for failing banks. Congress saw this when it passed the emergency provisions of the Garn-St Germain Act. The emergency provisions of that law allow large bank and thrift acquisitions across state lines under limited emergency conditions, but they expire in 1985. Interstate banking would simply make that principle permanent.

In addition, if larger banks are able to acquire deposits from a broader geographic area, they may be able to shift the focus of their deposit-seeking efforts from the money markets and abroad to a more stable base of domestic individuals and corporations. As you may have noted recently, the money markets frequently act like a stampeding herd; thus, a broader deposit base for large banks may ease our minds about events that might under present conditions make the markets nervous enough to start a run against a large bank.

On the other side of the safety coin, greater concentration of deposits in large banks would make some banks harder to handle in the event they get into trouble. It might also increase the geographic spread of the problems caused for their customers. Consequently, the pressure on regulatory and insuring agencies to shore up the large banks and, implicitly, to give them more incentive to take risks would increase.

This last concern worries me less than it might because I see less danger, in practice, that concentration will increase significantly and because large banks are likely to gain broader deposit bases and greater asset diversification by going interstate.

Our concerns about interstate banking's adverse implications for competition and safety are not great. There are certainly net benefits for financial service customers in interstate banking's effects on competition. Safety implications may be positive also. No epidemic of problem banks is likely, and we are ready to handle isolated cases in which banks have adjustment problems.

Activity Deregulation: More Benefits

Now let's turn to the area of activity or product deregulation. Expanding the limits on activities that financial institutions perform has taken place by law and market innovation over the past several years. Most of the legal changes have impacted thrifts. They are now allowed to serve most of the needs served by banks, but they have been slow to take advantage of their new powers. Market innovations have brought nondepository institutions into markets formerly served mainly by banks. Banks have made a few stabs at moving into the securities business.

Activity limits originally were placed on banks primarily to ensure that they would not take excessive risks and to avoid concentration of economic power. Our Research Department at the Atlanta Fed has recently done some studies and commissioned other studies on the need for these limits and on the reaction of bank customers to the idea of expanded activity powers for banks. Our conclusions should interest you.

Soundness of banks and the banking system seems to be much more closely related to banks' management of risk than to banks' ability to engage in risky activities. After all, we know that banks can already take enough risks to seriously harm themselves. A few of them have taken such risks and lost their bets, as you know. The number of commercial bank failures was already up to 43 by mid-July of this year. But most banks have managed their risks well enough to stay in business.

Studies of the risks involved in activities such as securities and insurance underwriting and brokerage and real estate brokerage indicate that making these activities available to banks would not necessarily increase banks' risk.

Indeed, in some cases, new activities afford the possibility of decreasing banks' overall risk. This can happen because the risk of the activity is less than that of banking—as is life insurance underwriting—or because income of an activity varies in a different time pattern from banks' income—as does income of securities brokers. Despite this possible risk-reduction effect, there will still be losers in any deregulation scenario.

The impact of product deregulation on concentration of financial resources is not likely to be threatening to the safety of deposits or the continuity of services from a bank. Activity deregulation has and will continue to introduce new competitors into most financial product markets. As I pointed out earlier, there is little evidence that there are substantial economies of scale in producing basic banking services, and the technology required for some services can be obtained by small institutions through service corporations or similar instruments. In addition, our antitrust laws are available to limit actual anticompetitive behavior.

On the one hand, activity deregulation itself should not increase public concern about the future safety of the banks or thrifts. Nor should it raise concerns about development of noncompetitive markets in which customers may be gouged.

On the other hand, a majority of consumers and a substantial minority of businesses appear to see some benefits from allowing banks to do such things as underwrite revenue bonds, underwrite and sell mutual funds, and act as insurance agents and underwriters. Being able to get these services at the same place that they get other important financial services may make their lives easier. Adding banks as competitors in the markets for these services may simplify their task of managing their financial resources.

Conclusions

The picture that I have painted of the future structure of banking is one which has good and bad news for you. The financial system is becoming more competitive. Customers should be able to find more providers of the services they need. This implies lower prices and better service quality. They will, however, have less chance of getting free rides. They will have to pay their way.

Customers may also find it necessary to become more conscious of the safety of the institutions that they deal with, although deregulation has not caused safety problems so far and seems unlikely to. However, if deposit insurers continue to experiment with partial payoffs of uninsured depositors, public concern about the safety of the banks may lead customers to critically analyze the banks' financial condition. If the public grows increasingly safety-conscious, lending officers will have to be sure to protect their institution's reputation for soundness. More and more customers may begin to find out just where to look on a bank's conditon report to spot the early symptoms of problems.

One final point I'd like to make is that interstate banking does not mean that funds will tend to leave their home state. That argument will not wash. If there are profitable opportunities to use deposits in your state, funds will find their way in. If there are not, even funds deposited with in-state banks will find their way out. Geographic and interest rate deregulation will help insure this free flow of funds.

You have some interesting times ahead as the structure of the financial industry continues to evolve. Some of the changes will cause you trouble. Most of them, however, will provide you with new opportunities as you find your bank able to offer a wider variety of services to a broader market. You will have to hustle to survive, but, if you and your bank can spot the opportunities early and have the skills to exploit them effectively, you can not only survive but thrive.