

**DEREGULATION OF THE FINANCIAL SERVICES INDUSTRY**  
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**To the Big Bend Chapter of the Bank Administration Institute**  
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Good evening! It is certainly a pleasure to be invited to join in your BAI meeting here in Tallahassee. I would like to use this opportunity to look at the current state of deregulation in the financial services industry. As you all know, deregulation is proceeding in fits and starts. Some significant advances have been achieved, but there are still major changes we need to make in order to attain the benefits that less regulation and more competition will bring.

The moratorium on new powers that was part of last August's banking act has expired. Though we may not see any real action before the election, I think there is more agreement than ever that several important issues need to be resolved without further delay. This gathering momentum places us at what may be another watershed in deregulation, particularly with respect to geographical deregulation and the expansion of banking powers.

What I would like to do this evening, then, is to give a brief overview of where we have come in the effort to deregulate banking. Next I will spend a few moments discussing the need for timely action to bring down the barriers to full nationwide interstate banking. After that, I will talk about how I feel we should go about addressing the issue of extending other new powers to banks.

### **The Accomplishments of Deregulation**

There is no need for me to go into the history of banking before deregulation. I am sure most of you remember well the days when banks were banks and thrifts were thrifts, when the differences between banking and commerce were sharply defined, and when interest rates were held in place by fixed ceilings. Some of you may recall them as the

"good old days," and in many ways life was simpler. Developments during that period, especially during the 1970s when the world around us was changing dramatically, left banks at a disadvantage in the face of competition from sources that were not regulated. In particular, technological innovations, especially in data processing and communications, and dramatic swings in interest rates created attractive opportunities for brokerage houses and other nonbank firms to offer some banking type services at better rates than banks could afford. Banks simply could not compete under these conditions.

The response of Congress, the bank regulatory agencies, and the states was a fair amount of ad hoc deregulation. Congress enacted the most important of these changes, deposit interest rate deregulation, in 1980. It was essential to allow banks and thrifts to pay competitive interest rates to keep these institutions liquid, and the legislation gradually removed almost all the ceilings on deposit rates. The Monetary Control Act in 1980 (MCA 80) extended the Fed's financial services to all depository institutions, regardless of whether they were members or nonmembers or banks or thrifts.

Another significant move was the expansion of thrifts' powers authorized by both MCA 80 and the Garn St Germain Act in 1982. The latter gave S&Ls and savings banks broader lending powers. It also allowed all depository financial institutions to offer accounts that earned interest and permitted some check-writing features--MMDAs and NOW accounts. On another front, the Comptroller relaxed restrictions on chartering new national banks, doing away with the test of economic need. For a time the Federal Home Loan Bank Board did the same for S&Ls. Regulators also provided for some deregulation by allowing banking organizations to form discount brokerages and investment advisory services.

State legislatures also took a hand in deregulation. Many of the states at first relaxed geographic restrictions on multioffice banking within their borders. Then as

Congress failed to act on interstate restrictions, the states took the issue into their own hands with a variety of interstate banking laws. States also attempted to provide some product deregulation by allowing the banks they chartered to engage in activities prohibited to national banks and nonbank subsidiaries of bank holding companies.

Despite the patchwork nature of these deregulatory gestures, in sum they have resulted in two major accomplishments. They have blurred the lines that once separated banks and savings and loans, and they have also attacked the walls between banks and nonbank financial institutions. The distinction between banks and thrifts was already becoming anachronistic by the early 1980s. This is a trend that I think will continue, given the availability of alternative forms of housing finance that are now available and the problems in many thrift institutions.

The Garn St Germain Act of 1982 also struck down some of the barriers between banking and other types of financial firms by allowing banks and thrifts to offer MMDAs and NOW accounts. The prohibition against banks' offering interest-bearing transactions accounts, along with the continued imposition of interest-rate ceilings, had originally been intended to wall banks off from other commercial enterprises and make them "special." Instead the regulations had fallen out of step with the realities of the time and were choking off depository institutions' profitability.

Banks are still struggling with profitability. Indeed, recent years' declining profitability figures could augur additional troubles. This problem is quite severe among the smallest banks, which suggests to me that we will see more failures as time goes on.

Chronic declines in profitability certainly point to some root cause, but observers are divided on the question of what that cause might be. Some see the culprit as inadequate deregulation, and there is certainly some truth to their arguments in regard to geographic restrictions. Others, especially banks, see the problem as a playing field

that is still not level. Banks are unable to offer a full range of services and view this state of affairs as especially constraining in the face of continuing competition from nonbanking companies. As I see it, however, several questions must be resolved before further powers can safely be granted. The most important of these is federal deposit insurance. I do not think it is wise to allow that safety net to underwrite any more risk than it already does. Consequently, in my view, new powers should only be considered--not enacted--until we have resolved the problems entailed in today's overly expansive safety net. Because geographic restrictions and new powers constitute two of the broadest areas of concern, I would like to address each of these two issues individually.

### **The Need to Finalize National Interstate Banking**

As you all know, bankers in the Southeast stood out as leaders in promoting the spread of interstate banking earlier in this decade. Florida and Georgia were among the first states to pass laws allowing bank holding companies from other states to purchase banks headquartered locally. However, this type of state banking legislation, which has also been adopted by other southeastern states, carried the condition that this privilege should be extended essentially within this immediate region. Banks from outside the region are still barred from entry.

While the regional compact arrangement was a progressive move at the time, the momentum of geographic deregulation has shifted to national rather than regional arrangements. Of the 40 or so states that have some form of interstate banking legislation on their books, seven permit unrestricted entry by holding companies from other states. A few others allow entry by banks from reciprocating states anywhere in the nation. By 1990 legislation now in force in about half the states will open their borders entirely to nationwide banking or at least allow such reciprocal arrangements.

Clearly, the most efficient way to proceed toward nationwide interstate banking

would be for Congress to enact such legislation. However, I do not think we will see any significant movement on the part of lawmakers in Washington in the near future. For that reason it may be time for state legislatures in this region to consider taking the initiative again and allowing entry to banks from outside the region. I think there are several reasons why further progress toward interstate banking makes good sense, both from the standpoint of bankers and consumers.

Let me begin by answering the argument of most opponents of nationwide interstate banking in the Southeast and elsewhere. These critics say that the local character of our banking markets should be protected against manipulation by outsiders. They view these outsiders as insensitive to local needs. In many ways, this is a reincarnation of earlier arguments against the expansion of bank holding companies within the states. Owners of small banks staunchly supported such a view because they feared they would not be able to compete against large, urban-based institutions. Indeed, a similar logic—one that was even more protective—had previously led to prohibitions against the opening of branch banks outside a parent bank's home counties. This provision is still on the books in some states.

Just as these past concerns proved to be unfounded, I feel there is no reason to believe that well-managed banks in our region would be damaged by the onset of nationwide interstate banking. The Southeast's banks are in excellent shape to meet competition from outside institutions. We can see this most easily when we compare banks by measures of capital rather than size. It is true that only a few of our banks rank among the top 25 in the nation from the standpoint of total assets. However, southeastern banks perform especially well when measured according to standards like profitability and capital-to-asset ratios, which give a better picture of relative strength. Our large banks actually begin to look dominant when we consider the prices of their stock. Their consistent good performance implies that investors remain bullish on

our region's banking institutions. The access to new markets that would come from liberalizing current restrictions could allow banks here to become even stronger.

At the same time, I have no concern that the responsiveness of banks to local conditions would disappear. Over the years, experience has demonstrated the need for close-up knowledge of local markets in making loans. Banks headquartered outside a local area have strong incentives to use people with such expertise because they may not be able to compete successfully in local markets if they fail to do so. Rather than becoming insensitive, it is much more likely that the outsiders will bring in new products and new ways of doing business. These innovations in turn will increase the variety of services available in the community and make for more competitive pricing. Local banks must adapt to new competition, but, when faced with challenges like these, most have shown that they can adapt successfully. At the same time, recent history in Atlanta, Florida, and elsewhere provides ample evidence that new banks will quickly be set up to take up the slack if existing institutions fail to meet local markets' needs.

For these reasons, I do not believe our banks and the communities they serve have any real need to fear competition from outside banks. In addition, there are tangible benefits which nationwide interstate banking would bring to consumers and businesses in this region—indeed, throughout the country. The most compelling case in favor of broader interstate powers is that greater competition among existing banks and the potential new entrants into local markets would tend to enhance banking products and prices for all of us. This would even be true for individuals and businesses in areas where no interstate banking firm actually set up shop. Just the possibility that such a competitor were "waiting in the wings" to pick up any slack in service would tend to enforce market discipline on existing banks.

When we add up the likely effects of full interstate banking, the benefits seem to outweigh the costs. Banks in the Southeast have much to gain from further developing

their links to money and capital markets outside our region. Our banks also have much to lose if they are left behind by financial institutions in other states and regions that are more directly and efficiently strengthening their integration to the nation's and the world's financial networks. Thus, I feel it is time to make a renewed effort to achieve full geographic deregulation.

### **Shrinking the Safety Net as a Basis for Further Product Deregulation**

Turning to the question of further product deregulation, I again believe there is much that needs to be done. In this case, however, the complexity of the issues requires that we proceed with caution. There are at least three factors that call for such prudence. First, not all institutions are healthy enough to withstand the stresses that deregulation would bring to bear upon them. Second, the public does not have sufficient information at its disposal to allow it to make intelligent choices among the more or less risky options with which deregulation could present them. Third, and most importantly, we have allowed the safety net provided by deposit insurance to become so extensive that it protects parts of the business that were not intended to be insured in the first place.

By insuring depositors, something to which we as a nation have become deeply committed, we have inadvertently created incentives to bank managers to undertake excessive risks, especially when their institutions are already facing problems. Moreover, because the implicit safety net has been broadened by bailouts of major failed institutions, it diminishes not only depositors' but also stockholders' and other creditors' incentives to monitor the activities of their financial institutions. This is the problem economists call moral hazard, but it is no mere economic abstraction. The cost of failures to the FSLIC ought to teach us this lesson. If we were to grant banks wholesale new powers in the present context, there could well be an enormous drain in the now healthy FDIC fund because new powers also often entail higher risks.

These difficulties have also been recognized by regulators and other financial industry analysts. Their thoughts have coalesced into several interesting proposals for restructuring the financial services industry. In general, though, those suggestions cling to the concept of a separation between banking and commerce. This division would be maintained by so-called "firewalls" or "Chinese walls," which would create barriers between types of institutions or between the various divisions within an institution.

What I propose is that instead of building or repairing walls to separate institutions, we focus our strategy on narrowing the safety net as a prelude to granting banks new powers over time. My proposal is to limit federal insurance to transactions accounts, which would be backed by U.S. government securities. These accounts could be offered by entities that were owned by financial holding companies. The other subsidiaries of such holding companies would eventually be allowed to perform even commercial activities. The fail-safe entities would, though, be distinct from all other affiliates including what we now know as banks and thrifts. The latter could also offer transactions accounts. However, like insurance, securities, and other liabilities that ultimately could be offered through affiliates of financial holding companies, bank and thrift liabilities, including deposits, would not be publicly insured.

This approach is, I feel, more practical than the major proposals for banking currently being discussed because it moves the focus away from the notion that we can control risk in the financial services industry by setting up a segmented structure for banking. As time goes on, any kind of walls we create to reinforce that structure will develop holes and crumble. This occurs partly because of the predictable economic incentives to avoid any binding regulation. In addition, as I said a moment ago, two of the major achievements of deregulation so far have been to bring down the walls between banks and thrifts on the one hand and between depository institutions and nonbank banks on the other. It makes no sense to halt or reverse progress in that direction.

You might be wondering why it is necessary to maintain one narrow, separate entity under these circumstances. Even though I do not think that banks should be treated as "special" in today's marketplace, in my opinion, money should be treated as a special element in the economy. Money serves as our most liquid asset. It is a sort of anchor at one end of the range of financial assets, and I believe that there is a legitimate demand from the public that the anchor be secured by the government. We can and we should meet that demand with a safe asset that will act as a transactions medium and link individuals and businesses to the payments mechanism.

A special entity offering checking accounts and holding only government securities would provide safety for money and be inherently constrained from taking substantial risks. Since fraud is always an unfortunate possibility, though, some government guarantee and supervision would probably be needed.

Once we have narrowed the safety net by providing that only the anchor asset would be insured and have educated the public regarding the new arrangement, we could then gradually begin granting expanded powers to banks. We would be left at that point with multi-activity holding companies which were chartered to offer insured accounts in an affiliate as part of their range of services. While particular activities would probably continue to be regulated, the organizational form would not be, with the exception of the insured depository. In that case, much of what is now done by bank examiners would become, for the most part, a market mechanism. The people to whom financial institutions owe money would increase their vigilance and exercise the power to punish excessive risk very quickly by withdrawing funds or demanding a higher return.

## **Conclusion**

As I suggested at the outset, I think we have a historic opportunity to make the banking system more responsive to consumer needs, more efficient, and more

competitive in the world economy. We can best seize that opportunity by moving to unify the various regulations now in force to achieve full nationwide interstate banking. We can take a second decisive step toward unifying the financial services industry by shrinking the federal deposit insurance safety net as a precursor to fuller product deregulation. I have no doubt that numerous challenges stand before us in the effort to achieve this consolidation of service and security. Nevertheless, I believe that by acting in a deliberate manner, we can work from our base in the present structure toward a redefinition of the financial services industry that acquits our obligation to maintain the safety and soundness of the system while at the same time moving us much closer to the goal of effective deregulation.