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The New World of Banking

I am honored to have been asked to speak with you this evening. This is an important occasion. Your work at the School of Banking reflects your commitment to banking. Even more importantly it reflects your desire to make an even greater contribution to your community. This is the type of commitment and desire that has made American banking so strong and vital. I am pleased to add my congratulations to each of you.

Commencement talks traditionally emphasize the challenges confronting the new graduate. I won't break that tradition. But you will find my approach somewhat different. The challenges I see are not only for you but for all of us--especially, some might even say, for those of us on my side of the bank regulatory fence.

Many exciting things are happening in banking today. Many challenges are facing the banking community. We are participating in a rapidly advancing technology, and the rise of the consumer movement. We are witnessing increased competition from the thrift institutions, and even increased inroads from nonfinancial firms into the business of banking. All of these have been discussed by virtually every student and practitioner of banking. The most important element that links these issues and others like them is what your Congress wants you to do and the regulatory climate in which banks must operate. Thus, a discussion of regulation, with its promises as well as its pitfalls, seems to me to be at the heart of any examination of the new world of banking. It is, therefore, the theme for my remarks this evening.

At the outset, I should make it clear that I do not oppose <u>all</u> regulation. That would be a misguided position. Indeed, where the costs rising from any activity are borne by a third party rather than by those engaged in that activity and are very large, and the costs, measured by the administrative difficulty and effectiveness of a regulatory solution are very small, regulation is clearly in order. I would only argue that such situations are not clearly as common as is generally believed. Moreover, it seems to me that many of the regulations currently in place in banking are inappropriate for the purposes they are designed to achieve. Many are, in fact, in direct conflict with one another.

There is a fundamental question as to whether or not the banking industry is one in which regulation is likely to offer great public benefits. The answer is by no means as clearcut as has often been assumed. To be sure, if one looks at the experience of the 19th century, with its recurring business depressions, liquidity crises, and waves of bank failures--which not only wiped out the savings of many depositors but temporarily crippled the payments system--one might conclude that strict regulation of banks was absolutely essential. This belief would only be reinforced by an examination of the 1920s. The overexpansion of banking before and during World War I, an agricultural depression lasting nearly a decade, and the decline of small rural towns, hastened by the advent of the automobile, combined to produce an average of over 500 bank failures a year between 1921 and 1929. For many, the ultimate proof of the need for detailed regulation of banking was given by the depression of the 1930s, when some 9,000 banks closed their doors.

Yet, a more critical appraisal calls into question the usual interpretation of the evidence available about American banking history. For one thing, it has bever been satisfactorily answered how much of the distress of the banking system in the 1930s was due to bad banking practice and excessive competition, and how much was due to preventable errors in macroeconomic policy, including the monetary policy pursued by the Federal Reserve. More recent studies of those years has tended to place much more weight on the latter, and correspondingly less on the former, than did students of banking in 1933. Much more important is the fact that the primary external cost related to banking that might be cured by regulation--that even well-managed banks often used to fail when a general distrust of banking led depositors to try to withdraw their funds--was, for all practical purposes, eliminated by the introduction of federal deposit insurance. Indeed, it might be argued that the primary justification for regulation of banks today is that the FDIC's insurance assessments are a flat percentage of total insured deposits rather than being based on the relative riskiness of bank portfolios. This subsidizes risk-taking. It makes it necessary to impose constraints on bank behavior.

Perhaps more than anything else, the conventional wisdom has held that it was excessive competition for deposits and the consequent "reaching for yield" in the form of riskier loans and investments that brought about the debacle of the 1930s. As a consequence, the most important restrictions placed on bank activity by the Banking Acts of 1933 and 1935 involve restrictions on entry into banking and on the payment of interest on deposits. During the subsequent 30 years, the effects of new entry restrictions was to reduce new capital investments in banking by an estimated 50 percent below what it otherwise would have been. Meanwhile, the interest ceiling restrictions, becoming inoperative when market rates fell far below the ceilings in the mid-1930s, had little effect. Beginning in the early 1960s, however, the interest constraints pinched banks more and more as the economy and loan demand expanded and bankers' memories of the Depression faded.

Partly as a consequence of a wave of bank mergers in the 1950s, students of banking, the banking regulatory agencies, and the Congress became concerned about maintaining competition in banking. This concern, after several attempts to adopt new legislation in the early 1950s, produced the Bank Holding Company Act of 1956 and the Bank Merger Act of 1960. It also resulted in several antitrust suits attacking collusive price fixing by local bank clearinghouses. The same concern over the lack of aggressive competition in banking led the Comptroller of the Currency in the early 1960s to ease restrictions on entry and to authorize banks to enter a number of new activities.

Thus it was that, by the early 1960s, a distinct inconsistency had developed in bank regulations. On one side regulation had the expressed purpose of restricting bank competition and risk-taking. Yet other laws and administrative rulings had the clear purpose of enhancing competition in banking. For example, freer entry and legal sanctions against merger or collusion to hold down interest rates on depositors' funds was intended to encourage banks to compete for funds. At the same time, Regulation Q ceilings on deposit rates either prevent such competition from occurring or force it to take other, nonprice forms. This inconsistency of purpose is what I would characterize as the schizophrenia of current bank regulation.

Of course, inconsistency is one thing; single wrongheadedness is something else. And it is under the heading of the latter that I would like to discuss the phenomenon of interest rate ceilings. Let us accept for the moment the conventional wisdom that banks need to be protected from excessive competition. It is, nonetheless, true that deposit rate ceilings, including the zero ceiling on demand deposits, have been the most costly and ineffectual interferences with the free market place ever devised by man. They are costly because competition has forced banks to resort to ever more circuitous and ingenious, but highly inefficient, means to circumvent the regulations in order to stay in business. Ineffectual both because the banks have kept a few stages ahead of the regulators most of the time and because other, less heavily regulated institutions have found ways to invade what formerly had been the exclusive preserve of commercial banks.

The net consequence of deposit interest rate ceilings through the years has been that the high costs the ceilings were designed to protect the banks from are still paid, but in a different form. Depositors have been deprived of the option of taking their interest in cash but are in effect forced, instead, to accept stuffed lions or kangaroos or a clock or a rose bush. Banks have lost position in the competitive financial markets. One of the few areas where the ceilings have been relatively effective is on small passbook deposits whose owners have few investment alternatives. There we witness the spectacle of the federal government, in all its majesty, enforcing a negative real rate of return on the savings of widows and orphans in order to maintain the profits of banks and thrift institutions. This is not a radical's perception of how the system works; it is a simply factual description of the effects of deposit rate regulation. It is this aspect of the ceilings that led the late Professor Ross Robertson of Indiana University to characterize Regulation Q as "wicked."

It would take more time than I have at my disposal to catalog the many and varied direct and indirect social costs of deposit interest rate ceilings through the years. Many of the most renowned financial "innovations" during the past two decades--the development of the negotiable CD market, Eurodollar borrowing by U.S. banks, the sale of loan participation notes, the sale of commercial paper by bank holding companies, the nonbank repurchase agreement market, the advent of NOW accounts, money market mutual funds, telephone transfers from savings accounts, and, most recently, automatic transfer accounts--are all costly and cumbersome means of getting around the law's proscription of the payment of market interest rates on deposits. What any first year economics student is taught to recognize as an economic absurdity has been codified for more than four decades as the law of the land.

The ramifications of the regulation of interest rates on deposits extend well beyond their costs to banks and bank depositors. One of these, which has come into the limelight recently, is what the ceiling have done to the informational content of the traditional monetary aggregates which the Federal Reserve must rely on in formulating monetary policy. The ceilings encourage the long-term growth of money substitutes. This, in turn, tends to produce a long-term upward trend of income velocity based on any narrow definition of money (with pronounced discontinuities marking the advent of major innovations in the financial system). Thus, the ceilings result in a confusing cyclical pattern in the relative growth rates of narrow and broad definitions of money. At the present time, for example, we are seeing a rapid growth of nonbank repurchase agreements, a large proportion of which function as demand deposits during most of the day before being taken off the bank's books at the close of business, thus making it more difficult to interpret even the basic thrust of monetary policy.

One may argue with some cogence that the most recent trends in regulation are in a generally sensible direction, toward the elimination of arbitrary price controls in banking. Certainly, the advent of NOW accounts and ATS accounts have moved us a long way toward the simple payment of interest on demand deposits. And the authorization a year ago of the issue of money market certificates tied to the Treasury bill rate has cushioned financial institutions against ceiling-induced disintermediation on the scale that had occurred in 1965 and 1969. Moreover, the testimony last week of Governor Partee before a House Banking Subcommittee makes it clear that the Federal Reserve now endorses in principle the payment of interest on demand deposits, desiring only that any such move be tied to a resolution of our Federal Reserve membership problem.

However, at the very time that sanity appears to be prevailing on one regulatory front, a disturbing new trend is making its appearance on other fronts. I am referring to the increasing tendency to regard the regulation of financial institutions as an appropriate means for effectuating broader social goals and the increased willingness to substitute official views of what is desirable for the judgments of the free marketplace.

This trend has it roots in the consumer movement of the late 1960s and 1970s. It has, however, moved far beyond Senator Paul Douglas' Truth in Lending law and its reasonable demand that bankers state, in as uniform, simple, and accurate a fashion as possible, what rate of interest they are are charging for various forms of credit. (To be sure, if Senator Douglas were alive today, he might be appalled at how complex and difficult to understand the regulations designed to implement this semmingly simple goal have become.) Examples of what I have in mind here are the Fair Credit Reporting Act of 1970, the Fair Credit Billing Act of 1971, and Equal Credit Opportunity Act of 1974, the Consumer Leasing Act of 1976, the Real Estate Settlement Procedures Act of 1974, the Home Mortgage Disclosure Act of 1976, the Community Reinvestment Act of 1977, and the Financial Institutions Regulatory and Interest Rate Control Act of 1978. These pieces of legislation have laudable purposes. They hopefully assure that people's credit records are accurately reported, that they are billed accurately on their revolving charge accounts and have adequate opportunity to make their complaints heard, that lessees have the terms of leasing contracts fully and accurately disclosed, that homebuyers are well in advance of the closing date of all charges related to the extension of credit on home mortgages, and that financial institutions actively serve the credit needs of the communities in which they are located.

On paper, these laws remedy most of the complaints consumers have made about the credit granting process over the past decade or so. In practice, however, it is often difficult to determine whether a particular financial institution is in compliance. It is even more difficult to assure that the laws will be observed in the future. The process of trying to do so involves enormous costs in terms of reporting disclosure, surveillance, and litigation. What has not been established with any degree of certainty is whether the benefits actually realized from the laws justify the costs of the regulatory apparatus designed to assure compliance with the laws. Some recent research suggests that the costs of compliance with the Equal Credit Opportunity Act--estimated at $293 million--exceed any plausible estimate of benefits. Indeed, some of the more careful research done in recent years fails to find evidence of either systematic discrimination on the basis of sex in lending or of the commonly charged offense of redlining, the systematic denial of credit to borrowers in certain areas of cities without regard to the actual lending risks involved.

This is not to deny that these types of discrimination may, in fact, occur in isolated instances. Of course, there is evidence of systematic discrimination in lending in some cases. But it suggests to me that consumers may be better served, in the overwhelming majority of cases, by relying on freer entry and more intense competition to assure fair treatment--not on forced compliance with an extensive regulatory apparatus. It is especially distressing that these laws were adopted in the absence of any credible estimates of the magnitude of the alleged problems they were designed to deal with or even the most remote notion of the costs of implementing them.

But, let us assume for purposes of argument that there have been some pervasive and well-documented abuses in the granting of credit that need to be remedied and that this can only be done by regulation. Nevertheless, there are serious grounds for objecting to several provisions of the laws enacted in recent years. For they go beyond assuring that the consumer is fairly treated and knows what he is paying. They go beyond what his obligations are. They arbitrarily dictate the substantive provisions of credit contracts and direct the allocation of credit toward areas or purposes deemed worthy by one or another special interest group or federal agency. Many examples can be cited:
High on the list are the limitations on the amounts a lender may require for tax and insurance escrow payments under the Real Estate Settlement Procedures Act, the current prohibition of variable rate mortgages to federally chartered savings and loan associations, the federal limitation of cardholder losses from unauthorized use of lost or stolen credit cards to $50, and the requirement under the Community Reinvestment Act that the geographic distribution of a bank's loans be considered in judging its application for a new branch. And it isn't only Uncle Sam who is so zealous. State usury ceilings, and the increasing restrictive state limitations on such creditors' remedies such as wage garnishment, wage assignments, deficiency judgments, and "holder-in-due-course" clauses, all inhibit sound financial dealings.

Some of these, like the restrictions on creditor remedies, simply raise the cost of credit to borrowers. They require borrowers who are good credit risks to subsidize the credit extended to poor credit risks.

But others, particularly the Community Reinvestment Act's emphasis on local lending, essentially require the bank's depositors and shareholders to subsidize what is deemed a worthy social goal--i.e., lending in declining areas of cities that pose above-average lending risks. Generally, one would think that the pursuit of such goals, it deemed worthy by the electorate, should be funded a broadly based tax as the federal income tax. But it appears that some prefer the indirect tax approach to be achieved by forcing financial institutions to invest in ways that are not in the interest of either their stockholders or their other customers. This may be simply because the proponents of such measures do not feel that they could get a straightforward, visible subsidy enacted into law. In any case, I think this whole approach of subsidization through what amounts to credit allocation--an approach long confined to policies designed to stimulate residential construction or rehabilitation--should come under closer scrutiny.

In the long run, of course, most of the laws and regulations that I have described become superfluous anyway. Ways are always found to circumvent them and new institutions are developed to carry on the activities prohibited to existing ones. In the meantime we suffer higher costs, an inefficient allocation of resources, and all the frustrations and limitations on freedom that accompany any arbitrary and rigid constraints on the market mechanism. And for every law or regulation that doesn't seem to work well, the solution seems inevitably to be more laws and more regulation.

Why the same tired measures continue to be tried, year after year and decade after decade, is something of a mystery. But it is not totally inexplicable. The fact is that many people--indeed perhaps most people distrust the free marketplace because they do not understand it. They fail to recognize that our system simply reflects the interaction of total wants of the entire populace (weighted, to be sure, by purchasing power), as embodied in total demands, with the inescapable fact of limited means, as embodied in supply conditions. They naively believe that the marketplace is likely to yield results that contradict what the populace actually desires. The propensity to regulate also stems from a myopic view of its effects--a view which fails to take into account its side effects and longer-term ramifications. This accounts for the "patchwork quilt" nature of the existing body of regulations, most of which were adopted as short-term, ad hoc responses to immediately perceived needs.

The antidote to this regulatory mentality is the broad, comprehensive long-term equilibrium framework of the economist. Naive optimism regarding their ability to make short run economic forecasts has cost economists a great deal of credibility in recent years. Nevertheless, the fact remains that the long-term consequences of specific regulations have been just about what economic theory would predict. Deposit interest rate ceilings at commercial banks have led to the development of money substitutes and the growth of competing institutions. Usury ceilings have led some institutions to cease lending in some states during periods of tight money. And to take an example from a different area, restrictions on gasoline prices have produced shortages and lines at filling stations. Ceilings on prices generally have either become totally ineffectual or, as has to some extent been true of deposit interest rate ceilings, have had to become increasingly encompassing in terms of institutional coverage. To the inveterate regulator, this fact--if it is acknowledged at all--is simply taken as a guarantee of job security. But, from a broader view of the public interest, one must wonder whether the game is worth the price of admission.

What I would like to leave you with is a considerably greater skepticism toward the frequently made promise of great benefits and minimal costs for someone's pet regulatory scheme. I believe that few such claims can stand up under the glaring light of close analysis. Even fewer can stand up under the longer term pressures of the free marketplace--and our economic freedoms are at the very heart of our democratic institutions and our personal freedoms. Let us never forget this simple fact.