

A NEWCOMER'S VIEW OF THE U. S. BANKING INDUSTRY

AS A NEWCOMER TO THE PUBLIC SECTOR OF THE U. S. BANKING INDUSTRY, IT WOULD BE PRESUMPTUOUS FOR ME TO SUGGEST A DIAGNOSIS AND CURE FOR ANY AND ALL PROBLEMS FACING THE PRACTICING COMMERCIAL BANKERS IN PENNSYLVANIA. ALSO, I AM NOT ADDRESSING MYSELF TO MONETARY POLICY MATTERS THIS MORNING, AND MAY I EMPHASIZE THAT I SPEAK ONLY FOR MYSELF AND NOT FOR MY COLLEAGUES IN THE FEDERAL RESERVE SYSTEM. MY REMARKS WILL REFLECT ONLY MY INTENSE PERSONAL INTEREST IN IMPROVING THE EFFICIENCY OF THE NATION'S FINANCIAL SYSTEM. INDEED, AS A NOVICE PUBLIC OFFICIAL, I HAVE FAR MORE QUESTIONS THAN ANSWERS.

MY PERSPECTIVE ON YOUR INDUSTRY IS DIFFERENT FROM THAT OF A MANAGEMENT CONSULTANT BECAUSE I AM CHARGED WITH RESPONSIBILITIES OF HELPING TO ACHIEVE MAXIMUM BENEFITS FROM THE OPERATION OF THE FINANCIAL SYSTEM FOR OUR ENTIRE SOCIETY, WHILE YOUR MAJOR RESPONSIBILITY IS TO YOUR SHAREHOLDERS. MY THOUGHTS ABOUT THE INDUSTRY BEGAN WITH MY EFFORTS TO LOOK AT MY OWN ACTIVITIES--NOT JUST AT WHAT I AM REQUIRED TO DO, BUT IN TERMS OF WHAT I, THE BANK, AND THE SYSTEM SHOULD BE DOING TO IMPROVE THE FUNCTIONING OF OUR FINANCIAL SYSTEM. THIS IN TURN GAVE RISE TO ALL KINDS OF QUESTIONS ABOUT YOUR ACTIVITIES---AND I WOULD LIKE TO SHARE A FEW OF THE QUESTIONS WITH YOU. I WOULD ALSO WELCOME AN OPPORTUNITY TO HAVE THE BENEFIT OF YOUR RESPONSE

TO THESE QUESTIONS.

THE REALLY FUNDAMENTAL ISSUE THAT CONCERNS ME THIS MORNING IS A BIG ONE: WHAT IS THE OPTIMUM FINANCIAL SYSTEM FOR THE U. S. TODAY? NOW I KNOW THAT YOU ARE AS INTERESTED IN THE ANSWER TO THIS QUESTION AS I AM, BUT OUR INTERPRETATIONS OF THE QUESTION MAY DIFFER. LET ME AMPLIFY THIS POINT. WHEN I ASK YOU WHAT WOULD YOU CONSIDER TO BE THE OPTIMAL BANKING SYSTEM, WHAT I AM REALLY ASKING IS WHAT KIND OF BANKING INDUSTRY WOULD YOU, THE PRACTICING BANKERS, CREATE IF THERE WERE NO REGULATORY AUTHORITY TO CONSTRAIN YOU, KEEPING IN MIND THAT THERE WOULD STILL BE A MONETARY AUTHORITY TO MEET THE COUNTRY'S CHANGING NEEDS FOR MONEY. ALTERNATIVELY, WHAT SHOULD BE THE BUSINESS OF BANKING? WOULD YOUR PRODUCT-MIX OR ACTIVITIES BE DIFFERENT THAN NOW?

PRESUMABLY, IF YOU WERE FREE TO DO SO, EACH OF YOU WOULD PROCEED TO DEVELOP YOUR INSTITUTION AS ONE BEST SUITED TO YOUR OWN NEEDS. THE RESULTING BANKING STRUCTURE WOULD BE A SUMMATION OF YOUR INDIVIDUAL CHOICES. AS A PUBLIC OFFICIAL, I HAVE A DIFFERENT PERSPECTIVE. WHEN I CONSIDER WHAT IS THE OPTIMAL OR IDEAL BANKING SYSTEM, I MUST THINK IN TERMS OF THE BENEFIT TO OUR ENTIRE SOCIETY. THE IDEAL BANKING SYSTEM FROM THIS

VIEW IS ONE THAT PROVIDES THE DESIRED LEVEL OF BANKING SERVICES AT THE LOWEST POSSIBLE COST. WITH SUCH A BANKING STRUCTURE, WE WOULD OBTAIN AN OPTIMAL ALLOCATION OF SCARCE RESOURCES AND A STABLE MONETARY STRUCTURE. IT IS IMPORTANT TO KNOW HOW FAR YOUR IDEAL IS FROM SOCIETY'S BECAUSE OF THE IMPLICATIONS THIS HAS FOR THE APPROPRIATE DEGREE AND TYPE OF BANKING REGULATION.

MY POINT IS THAT THE PRESENT SET OF BANK REGULATIONS IS NOT NECESSARILY CONSISTENT WITH EITHER OF OUR IDEAS REGARDING AN OPTIMAL BANKING SYSTEM. BECAUSE THERE IS INCREASING SENTIMENT ALONG THESE LINES, IT SEEMS QUITE POSSIBLE THAT CHANGES ARE IN STORE FOR US.

BUT LET'S GO BACK TO THE BEGINNING. BANKING IS NOT ONLY A VERY IMPORTANT INDUSTRY IN THE SENSE THAT IT IS THE PRODUCER OF THE NATION'S MONEY SUPPLY AND THE PRINCIPAL ARM OF MONETARY POLICY, BUT IT IS ALSO A VERY REGULATED INDUSTRY. TODAY, BANKS ARE SUBJECT TO CONTROLS AFFECTING THEIR NUMBER, THEIR ORGANIZATIONAL STRUCTURE, THE TYPE OF SERVICES THEY CAN OFFER, THE COMPOSITION OF THEIR ASSETS, THEIR CAPITALIZATION, AND THEIR LOCATION--TO MENTION A FEW THAT COME MOST READILY TO MIND. ALTHOUGH THE FEDERAL RESERVE IS NOT THE ONLY REGULATORY AGENCY FOR THE INDUSTRY, WE DO CONTRIBUTE OUR SHARE, INCLUDING REGULATIONS

A THROUGH Z, EXCEPTING W, FOR MEMBER BANKS. ADDITIONAL CONSTRAINTS ARE IMPOSED ON THE BEHAVIOR OF COMMERCIAL BANKS BY THE FDIC, THE COMPTROLLER OF THE CURRENCY, AND STATE BANKING AUTHORITIES.

BUT WHY DO ALL THESE REGULATIONS AND RESTRICTIONS ON BANKING EXIST? THE STOCK ANSWER HAS BEEN THAT THESE REGULATIONS WERE INSTITUTED TO INSURE THE STABILITY AND SAFETY OF THE BANKING SYSTEM.

IN THE FACE OF ALL THIS SUPERVISION, ONE MIGHT GET THE MISTAKEN IDEA THAT BANK REGULATIONS ARE THE PRINCIPAL DETERMINANT OF THE NATURE OF THE COMMERCIAL BANKING SYSTEM. IN FACT, OF COURSE, THE ANTI-TRUST LAWS AND THE BASIC LAWS OF ECONOMICS ARE PROBABLY MUCH MORE SIGNIFICANT INFLUENCES ON THE NATURE AND STRUCTURE OF THE BANKING SYSTEM.

YET, IT DOES SEEM THAT THE SAFETY OBJECTIVE OF REGULATION HAS BEEN ACHIEVED. IN THE POSTWAR PERIOD, BANK FAILURES HAVE BEEN INFREQUENT. IN THE FEW EXCEPTIONS WHEN BANKS HAVE FAILED, THEY HAVE OFTEN BEEN ABSORBED BY OTHER BANKS. WHEN INSURED BANKS HAVE CLOSED, THE LOSS TO DEPOSITORS HAS BEEN SUBSTANTIALLY DIMINISHED BY DEPOSIT INSURANCE.

WHAT IS ALSO APPARENT TO ANY OBSERVER IS THAT THESE REGULATIONS HAVE HAD EFFECTS OTHER THAN STABILIZATION OF THE NATION'S FINANCIAL SYSTEM.

ONE WAY OF GETTING AT THESE EFFECTS IS TO ASK THE QUESTION THAT I ASKED EARLIER: WHAT WOULD BE THE EFFECT ON YOUR OPERATIONS IF ALL BANKING REGULATIONS WERE REMOVED? HOW WOULD THE BANKING INDUSTRY DIFFER? WHAT WOULD YOU DO THAT YOU ARE NOT DOING NOW AND HOW WOULD YOU DO IT IF THE BANKING REGULATORY SCAFFOLDING WERE REMOVED? OBVIOUSLY, THERE ARE A NUMBER OF ALTERNATIVE ACTIVITIES IN WHICH YOU COULD BE ENGAGED. BUT, I WONDER, DO YOU HAVE--IN THE SHORT RUN--THE MANAGEMENT RESOURCES TO DO SOME OF THESE THINGS? AND--IN THE LONG RUN--WOULD THEY BE PROFITABLE USES OF YOUR RESOURCES? I GUESS THAT I AM GOING BACK TO THE BASIC QUESTION OF WHAT IS THE BUSINESS OF BANKING? ARE YOU IN THE BUSINESS OF PROVIDING A RANGE OF SERVICES TO THE LOCAL COMMUNITY OR IS IT MORE DESIRABLE FOR YOU TO SPECIALIZE IN A LIMITED NUMBER OF PRODUCTS OR TO OPERATE IN DISTANT MARKETS TO MAXIMIZE PROFITS?

REMEMBER, HOWEVER, THAT YOU WOULD REMAIN SUBJECT TO OTHER RESTRICTIONS. SOCIETY'S INTERESTS ARE SERVED WELL BY COMPETITION, AND THE ANTI-TRUST TRADITION IS DEEPLY ROOTED IN THIS COUNTRY.

THE FACT REMAINS THAT BANKING REGULATIONS--AS WELL AS ANTI-TRUST LAWS AND THE REALITIES OF ECONOMICS--HAVE HAD EFFECTS ON THE OPERATIONS OF THE BANKING INDUSTRY IN ADDITION TO THE EFFECT

ON SAFETY. THERE ARE UNANTICIPATED COSTS AS WELL AS ANTICIPATED BENEFITS FROM DETAILED REGULATION. THE MOST OBVIOUS SUCH COST IS SOME LOSS OF INSTITUTIONAL FLEXIBILITY, WHICH IS HARMFUL BOTH TO PUBLIC AND PRIVATE INTERESTS. RESPONSIBLE PUBLIC OFFICIALS MUST BE CONCERNED ABOUT THE TOTAL IMPACT OF AN ACT OR REGULATION. WE MUST KEEP ASKING: ARE THE COSTS OF A REGULATION LESS THAN THE VALUE OF THE BENEFITS OF THAT REGULATION TO SOCIETY? CAN A DIFFERENT SET OF REGULATIONS BE DESIGNED TO ACHIEVE THE SAME DESIRED GOALS AT A LOWER COST? WHAT IS THE IDEAL (HIGHEST BENEFIT-LOWEST COST) REGULATORY STRUCTURE? THESE ARE QUESTIONS THAT WE MUST CONTINUE TO EXPLORE.

LET ME GIVE SOME EXAMPLES OF THE EFFECTS OF REGULATION WHOSE COSTS AND BENEFITS HAVE TO BE CONSIDERED IN THE EVALUATION OF THE PRESENT SET OF REGULATIONS.

FIRST, I THINK WE CAN AGREE THAT PUBLIC POLICY HAS INFLUENCED THE NUMBER, SIZE, AND ORGANIZATIONAL STRUCTURE OF BANKS. IT HAS DONE SO, FOR EXAMPLE, THROUGH RESTRICTIONS ON DE NOVO ENTRY AND BRANCHING AND THROUGH THE CONCERN FOR COMPETITION AMONG BANKS. DEVELOPMENTS IN THE STRUCTURE OF THE BANKING INDUSTRY HAVE MIRRORED REGULATORY CHANGES AND JUDICIAL RULINGS, AS WELL AS ECONOMIC FACTORS.

FROM THE BANK MERGER ACT OF 1960 UNTIL THE  
END OF 1971, ALMOST 20% OF THE BANKS IN THE  
FOURTH DISTRICT WERE ABSORBED THROUGH MERGER  
ACTIVITY. WE ARE CURRENTLY OBSERVING A REGULATION--  
CONSTRAINED EXPANSION OF ONE-BANK HOLDING  
COMPANIES INTO BANK-RELATED ACTIVITIES. JUDICIAL  
RULINGS ON MERGER CASES IN THE FIRST HALF OF THE  
1960'S AND THE BANK MERGER ACT OF 1966 AFFIRMED THE  
APPLICABILITY OF ANTI-TRUST LAWS TO THE BANKING  
INDUSTRY. THE BANK HOLDING COMPANY AMENDMENTS OF  
1970 PLACED ONE-BANK HOLDING COMPANIES UNDER THE  
REGULATORY JURISDICTION OF THE FEDERAL RESERVE.  
IT IS EVIDENT, THEREFORE, THAT PUBLIC POLICY IN  
THE FORM OF STATE STATUTES, COURT RULINGS, AND  
NATIONAL LEGISLATION BLEND TO FORM BANKING'S LEGAL  
ENVIRONMENT, AND SUCH AN ENVIRONMENT IS LIKELY TO  
BE RETAINED NO MATTER WHAT CHANGES ARE MADE IN  
THOSE DETAILED REGULATIONS SPECIFIC TO BANKING.  
MOREOVER, WHETHER ONE TAKES A BANKER'S VIEWPOINT  
OR THE PUBLIC PERSPECTIVE, WE NEED TO KNOW:  
WHAT IS THE MOST EFFICIENT SIZE BANK? I DO NOT  
KNOW THAT THIS QUESTION CAN BE ANSWERED WITHOUT  
SPECIFYING THE EXTENT OF THE MARKET OR THE TYPE  
OF BANKING SERVICES EFFECTIVELY DEMANDED, BUT  
SOME STUDIES HAVE SUGGESTED THAT PER UNIT COST  
OF BANK SERVICES DOES NOT DIFFER SIGNIFICANTLY

FOR A WIDE RANGE OF BANK SIZES FROM, SAY, LESS THAN \$5 MILLION TO \$500 MILLION IN DEPOSITS. THIS IMPLIES THAT BANK GROWTH IS NOT A ROYAL ROAD TO LOW COSTS AND RAISES QUESTIONS ABOUT THE BENEFITS TO SOCIETY OF INCREASING CONCENTRATION IN BANKING. MOREOVER, INsofar AS REGULATION HAS INFLUENCED BANK STRUCTURE, ONE WONDERS IF, ON BALANCE, THE EFFECT HAS BEEN TO THE ADVANTAGE OF SOCIETY AND/OR THE INDUSTRY.

REGULATIONS HAVE ALSO AFFECTED THE COMPOSITION OF ASSETS HELD BY U. S. COMMERCIAL BANKS. AND, AGAIN, IT IS WORTH ASKING IF THE NET EFFECT HAS BEEN POSITIVE OR NEGATIVE TO THE INDUSTRY AND SOCIETY AS A WHOLE. I HAVE IN MIND REGULATIONS SPECIFYING THE LEVEL AND TYPES OF ASSETS THAT MUST BE HELD AS RESERVES. RESTRICTIONS ALSO APPLY TO THE TYPES AND AMOUNTS OF LOANS AND INVESTMENTS THAT MAY BE MADE. IT APPEARS THAT THE GOAL OF A STABLE BANKING SYSTEM HAS BEEN MET, BUT WHAT COSTS HAVE BEEN INCURRED? THESE REGULATIONS HAVE AFFECTED THE FLOW OF FUNDS TO SECTORS SUCH AS HIGH-RISK VENTURES AND LONG-TERM CAPITAL INVESTMENT. MY POINT IS THAT REGULATIONS DESIGNED TO ENHANCE THE STABILITY OF THE BANKING SYSTEM HAVE HAD EFFECTS THAT ARE BEYOND THOSE INTENDED, AND THESE EFFECTS

MAY BE UNNECESSARILY PUSHING US AWAY FROM AN IDEAL SITUATION BOTH FROM SOCIETY'S AND THE INDUSTRY'S VIEWPOINT. WE MUST BE CONTINUALLY ALERT TO THE POSSIBILITY THAT REGULATIONS MAY BECOME RESTRICTIVE OF INNOVATION RATHER THAN PROTECTIVE OF THE PUBLIC INTEREST.

REGULATION HAS ALSO AFFECTED THE VERY NATURE AND COMPOSITION OF BANKING LIABILITIES VIA RULES REGARDING THE DEFINITION OF DEPOSITS, RESERVE REQUIREMENTS, AND INTEREST LIMITATIONS, FOR EXAMPLE. ONE EFFECT OF THESE REGULATIONS THAT IS DIFFICULT TO RECONCILE WITH A SOCIETAL POINT OF VIEW IS THE DISCRIMINATION AGAINST SMALL SAVERS THAT HAS OCCURRED DURING PERIODS OF HIGH INTEREST RATES. THERE IS ALSO A DANGER HERE THAT OUR REGULATIONS HAVE RESTRICTED INNOVATION IN THE PROVISION OF SERVICES--ALTHOUGH AT TIMES IT APPEARS THAT OUR REGULATIONS HAVE SPURRED REALLY IMAGINATIVE, BUT COSTLY, METHODS OF AVOIDANCE.

THIS MORNING, I HAVE TRIED TO CHALLENGE YOU TO THINK ABOUT WHAT THE BANKING INDUSTRY SHOULD BE. IT IS CLEARLY A HEAVILY REGULATED INDUSTRY. WE MUST CONSTANTLY EVALUATE THE TOTAL SOCIETAL EFFECTS OF REGULATION AND WEIGH THEIR COSTS AND BENEFITS. THERE ALWAYS REMAINS A POSSIBILITY, THEREFORE, THAT THE TYPE AND DEGREE OF REGULATION

WILL BE CHANGED TOWARD A DIFFERENT SET OF PUBLIC RESTRICTIONS, PERMITTING PERHAPS MORE COMPETITION WITH LESS EMPHASIS ON THE SURVIVAL OF SPECIFIC INSTITUTIONS. THAT IS CERTAINLY THE DRIFT OF THE HUNT COMMISSION REPORT. THE FEDERAL RESERVE MUST CAREFULLY WEIGH THE LONG RANGE CONSEQUENCES IN TERMS OF COSTS AND BENEFITS OF THE PRESENT AND ALTERNATIVE SYSTEMS. PERHAPS WITH OPEN LINES OF COMMUNICATION BETWEEN THE PUBLIC AND PRIVATE SECTOR, WE CAN APPROACH A SYSTEM THAT IS CLOSER TO THE IDEAL FINANCIAL STRUCTURE THAT ALL OF US DESIRE.