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REGULATION TOMORROW:  
TOWARD A NEW FRAMEWORK FOR COMPETITION

Remarks by  
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Not long ago, a thoughtful banker stood on a platform like this and spoke on the theme that "banking isn't fun any more." We all know what he meant and we understood well his point: the regulatory burden faced by banks is becoming heavier and it seems to be getting in the way of a banker's ability to do the job he wants to do in his community.

I'd like to add my variation to that theme: Bank Regulation Isn't Fun Any More. In large measure, the traditional opportunity for bankers and regulators to work together, in the interest of a sound banking system responsive to the needs of the public, has been seriously diminished.

As we all know, the winds of social change and politics have blown a blizzard of legislation over banking. More than 15 major new pieces of legislation affecting banks have been sent forth from Congress in just the past decade or so. As a regulator, I am sensitive to the fact that regulators are more or less in the middle—striving as you are to adjust to the constant demands of new legislation and the inevitable regulations, while seeking to continue to serve the banking industry effectively with as little oppression as possible. The result: some days it just isn't fun anymore. But it's not hopeless. There are good opportunities ahead for thoughtful bankers to work with regulators and legislators to develop a system that acknowledges the complementary needs of financial institutions and the public. And the opportunity for all like financial institutions—including S & L's, mutual savings banks, and others—to compete on an equal basis should be the central theme of our mutual efforts.

I am convinced that a financial system which permits the principles of the free market to operate, unfettered by oppressive regulation, is the most efficient way to allocate the total financial resources of our nation.

As you know, much of the current regulatory framework is a heritage of the traumatic 1930's, when laws were implemented to bring stability to a chaotic banking system and to restore public confidence in a banking system viewed with distrust. These laws emphasized protection of bank depositors and prevention of bank failure.

Experience confirms that many of these laws, such as the creation of the Federal Deposit Insurance Corporation, served their purpose well. Other laws, however, written for another time and purpose, now serve only to reduce competition without appreciable improvement in bank soundness and safety. A key example is interest payment restrictions on demand and savings deposits originally designed to prevent "excessive" competition among banks.

The regulatory legacy of the 1930's is still with us. However, recent changes in technology, together with the growing competition from nonbank financial institutions, and continuing inflationary pressures have resulted in strong incentives to alter piecemeal much of this regulatory structure. Although the soundness of our financial system must continue to be of paramount concern, increasing emphasis needs to be given to competitive considerations if banks are to compete effectively with other financial institutions to continue to serve the deposit and credit needs of the public. Thus, it seems to me that increased emphasis on competition will be a primary ingredient of future bank regulation.

I want to spend a few minutes to look at some of the current bank regulatory issues concerning financial competition and examine how they set the basis for my views about what's ahead in bank regulation. Specifically, how will proposed changes promote competition and efficiency in our financial system while also insuring bank soundness? Since the effects of these changes are interdependent and bear on the structure of our entire financial system, not just banks, a comprehensive approach toward regulatory reform is needed to ensure a financial sector which is both competitive and sound.

One major area in which legislative and regulatory reform will significantly increase competition—and ultimately economic efficiency—is the payment of interest on all types of deposits. The regulations on ceiling interest rates and the outright prohibition of payment of interest on demand deposits are rooted in the Banking Acts of 1933 and 1935. These laws arose out of the dangerously unstable condition of our banking system in the depths of the Depression. Since that time, Congress has extended this ceiling rate authority 13 times, most recently through Title 16 of FIRA, which extends the authority to set interest rate ceilings on time and savings deposits through 1980.

In the past few years, increased pressures have been mounting to eliminate the prohibition against the payment of interest on demand deposits and to phase out what we know as Regulation Q ceilings. These pressures stem from two sources: the rise in the inflation rate and the public's desire to receive a fair rate of return on their deposits. As recently as 1976 the six-month Treasury bill rate was 5.25 per cent, about the same as the

Regulation Q ceiling on passbook savings. Since that time, however, the Treasury bill rate has jumped to 9.5 per cent, while the passbook ceiling rate for commercial banks has remained at the 1973 level of 5 per cent (5.25 per cent as of July 1). To compensate for the disparity between market rates and those allowed under Regulation Q, new savings instruments have been authorized and introduced. The result has been the slow evolution of a complex array of time and savings instruments with varying interest rates and maturities. These instruments, now in 15 varieties, have confused savers, have led to discrimination among classes of savers, and have in some measure lessened the incentive of the public to save.

Depositors, however, are not the only ones penalized by interest rate ceilings. Regulated financial institutions are also hurt.

While financial institutions have experienced increased operating costs associated with the multiple types of instruments available to depositors, more importantly they have suffered serious problems of disintermediation during periods when market rates rose above those allowed under Regulation Q.

Although some argue that interest rate ceilings are necessary to ensure a source of stable and low costs funds to the borrowing public, the ceilings have not provided that result. Rather, the flow of funds away from institutions subject to Regulation Q provisions has periodically caused a shortage of funds for borrowers at times when these institutions could not compete with other market rates.

It is fair to say that our recent experience with interest rate prohibitions and ceilings has been less than satisfactory. The problems they have created have led to increased regulatory and legislative efforts to do away or sidestep them. For example, the

NOW accounts permitted in New England and New York provide depositors an interest-bearing transaction account. Automatic transfer services and bill-paying arrangements, until struck down by the United States Court of Appeals in April, provided depositors outside New England and New York with an indirect method of earning a return on demand balances. Currently, bills are pending in Congress which would phase out or abolish interest rate prohibitions and ceilings, and the current administration has put its support behind a gradual phase-out of all deposit interest rate controls. In my judgement, one result of these trends and developments is that we are on the threshold of having Federal legislation to authorize NOW accounts for like financial institutions—including banks—on a nationwide basis.

Another area where legislative and regulatory change is likely to occur and result in increased competition is the further relaxation of branching restrictions on financial institutions.

In recent years the branching topic has become increasingly important as technological progress and the growing incursion by other institutions into the traditional banking service areas has required greater competitive flexibility for banking. Advances in electronic payment mechanisms and the sharing of facilities by different banks and other financial institutions have led to the development of statewide and regional electronic transfer systems. With the growth in electronic banking has come an erosion in the importance of political boundaries in governing competitive interaction among financial institutions. Banks have, or soon will have, the capability to serve their customers electronically over great distances. Restrictive state branching laws, which did not anticipate such advances in our payments mechanism, or the ability

to perform interstate and even international business through loan production offices or Edge corporations, must adapt if our banking system is to compete effectively with other financial and nonfinancial institutions unfettered by such restrictions.

To the extent that state branching laws are not sufficiently flexible to allow banks to compete with these new technologies, they will force the creation of innovations to circumvent their restrictions.

In my judgement, technological and competitive considerations will bring increasing pressure for reform in state branching laws. This reform may come in "fits and starts" with development of reciprocal branching agreements among states and the linking of EFT systems. But most of us would prefer that reform evolve in a more comprehensive and efficient mannner by allowing nationwide linking of electronic systems among many types of financial systems while clearly defining the allowable types of transactions. Such an approach would assure that no state would be left at a competitive disadvantage and it would allow financial institutions to plan for the future in a more certain environment.

Another competitive issue—one that member banks constantly remind us about at the Federal Reserve—is reserve requirements. Member bankers feel strongly that the costs of holding idle reserves have hindered them in competing with nonmember banks and financial institutions. And as more and more types of institutions begin to offer transaction services, greater attention will have to be focused on establishing equitable reserve requirements. Increasing competition for sources of funds, rapid inflation, and the high interest rates have combined to force

bankers to take a close look at the cost of membership. Many banks have reacted by withdrawing from the System. From 1945 to 1970 the proportion of U.S. banking deposits controlled by member banks fell from 86 per cent to 80 per cent; but from 1970 to 1979 that percentage has shrunk to 72 per cent, complicating the Federal Reserve's monetary policy implementation. Aside from the membership implications of the reserve burden, a number of economists have attacked the present system of required reserves because it is inefficient and allocates resources poorly. These economists question whether a desired level of investment in banking can occur relative to other industries if bankers are required to hold a portion of their assets in nonearning balances.

Thus, if our banking system is to be competitive with other financial institutions, both here and abroad, and with other industries in the economy, the burden of idle reserves must be eliminated. As well documented in industry discussions of the Federal Reserve membership issue, lower reserve requirements and/or the payment of interest on reserves are the two primary methods suggested for lessening this reserve burden.

Colorado member bankers may be assured that the Federal Reserve Bank of Kansas City will continue to urge an early resolution of the membership issue and an easing of the reserve burden.

In summary, we know now that some of the 1930's banking legislation serves only to reduce banking competition without producing any measurable gains in the efficiency of the banking system. Moreover, as a result of restrictions on bank activities and deposit interest rates, and partly a result of banker attitudes, the role of commercial banks in the financial sector

has been gradually usurped by other financial intermediaries and new credit arrangements. This change has become more rapid since the late 1960's as the burdens of interest ceilings and reserves have increased with inflation and as technology has fostered new payment practices. Banks have been particularly vulnerable to this combination of circumstances, given the nature of their assets and their special need to attract both deposits and capital.

What concerns me most about this financial growth and development outside of the banking sector is that it has occurred not because banks lost their desire to deliver financial services in an efficient way, but because banking law was too slow to adapt to changing conditions and the demands of the public. Therefore, as bankers and regulators, we both have an interest in developing and supporting a new regulatory framework which insures that commercial banks are allowed to offer competitive services to the public. At the same time that framework must preserve the essential features which contribute to a sound banking system deserving of public confidence.

If we continue to embrace the outdated—and largely anti-competitive—aspects of the banking laws of the 1930's, which have led to a "band-aid" approach to financial institution problems, then the confusing morass of piecemeal, patchwork fixes which are so characteristic of legislative and regulatory response will continue to hold us back.

Change, and now accelerating change, has brought us a new ball game. This game demands a comprehensive understanding of how the game is to be played, not rules made up by the umpires and the people in the stands as the game goes along. I will

support—and you should support—a fundamental review of the environment in which financial institutions operate and compete today, with a view toward legislating a financial system which recognizes the importance of improved competition in the financial arena. Furthermore, we should support development of a system which has as an ultimate objective the economic efficiency of our financial structure.

As these issues of the future framework of our financial structure are aired in national forums in the period ahead, I know that thoughtful bankers will continue to draw upon their experience to counsel their lawmakers and regulators. I hope that legislators will consider fully the traditional principles of free enterprise in their decisionmaking. I hope we can establish a financial structure where all like institutions can compete equitably. Let us have reasonable equity in requirements for capital, liquidity, and taxation. Let the marketplace decide what institutions should provide what services and at what prices.

In closing, I want to say that as change inevitably occurs in banking, and as bankers and regulators join to encourage a responsive regulatory framework for financial institutions, the Federal Reserve would intend to work with you in supporting a system which acknowledges your needs and meets the needs of your customers.