

AFTER DEREGULATION:
THOUGHTS ON BANKING TOMORROW

Remarks by
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When I last addressed this convention some six years ago, my theme that day was the challenge of managing change. With hindsight, what an appropriate theme that was! Few of us predicted then that the momentum of change in banking which we saw developing would impact banks so sharply and so quickly. Moreover, who could have foreseen that the momentum of change would be propelled so energetically by the forces of deregulation. Given the extent of deregulation now in prospect for financial institutions, someone has suggested that five years from now a speaker on this platform will be addressing the Nebraska Financial Institutions Association!

I really don't believe that the NBA will change its identity that much over the next few years. But I certainly agree that the process of financial deregulation and the resulting adjustments in financial service markets do contain elements of inconsistency, uncertainty, and frustration.

In view of these uncertainties and frustrations, I want to discuss with you today some ideas about the probable shape of banking after deregulation. In doing so, I want to draw on the experience of other previously regulated industries which have been or are being deregulated, and I want to discuss the implications--as I see them--of deregulation for the various types and sizes of banks.

As you know, deregulation is rooted in the mood of the American public. This mood reflects public discontent over the encroachments of regulation into the marketplace. Congressional

legislation in recent years affecting the securities industry, the airlines, the trucking industry, and financial institutions--through the Monetary Control Act--all witness to the mood of the public and government in favor of reliance on market forces.

In banking as in all these industries, the legislative response arose from problems caused by underlying economic imbalances. In banking, for example, nonbank competitors such as brokerage houses are not required to operate under the same regulatory restraints as banks. And recent innovative products being offered by nonbank competitors have underscored this imbalance. You all are familiar with the Merrill Lynch cash management account, and perhaps you have heard of that firm's intention to become a commercial lender. In response to this new competition from many unregulated entrants, current deregulation efforts are designed to "level the playing field" so that all industry participants can compete on more even terms.

I believe you would agree that it is not the responsibility of regulation to foster structural change nor is it to protect the regulated. However, regulation does owe the public a safe, sound, efficient, competitive, and fair financial system. Regulations which do not meet this criterion should be discarded. Even now, for example, regulations that restrict interest payments and intra- and interstate banking activities are under serious attack.

Because interest rate deregulation is so fundamental in bringing about equity among participants in the financial system,

this step is long overdue. In fact, when bankers are again able to compete on price with all providers of financial services, bankers' concerns about the stability of their deposits will be eased considerably. In the meantime, the uneven nature of interest rate deregulation through DIDC actions so far has been a cause of considerable frustration to bankers. However, it should be remembered that most periods of transition are not smooth, and despite short-term irritations, the trend towards deregulation is a reality which cannot be ignored and must be prepared for.

In preparation for the ultimate deregulation in the financial industry, and to make judgements about the shape of banking in a new environment, I think it is useful to look at the results of deregulation in other industries that have worked through a similar experience. One view of the process and results of deregulation elsewhere has been offered by Donald Waite of McKinsey & Co. Waite recently studied the impact of deregulation on five previously regulated industries--securities brokerage, business terminal equipment, airlines, trucking, and railroads. The Waite study concluded, for one thing that strong firms expanded into formerly protected markets and accelerated new product entries. Another finding was that new suppliers of services entered the market with low-cost options. In particular, he noted five distinct results of deregulation among the industries studied:

- Earnings become highly variable among firms within the industry, largely because of weak firms rapidly becoming weaker rather than strong firms becoming stronger. It is clear that increased competition puts pressure on the earnings of marginal performers of all sizes.
- The most profitable products come under the most severe price pressure as competition increases.
- Products lines become unbundled while new and complex product/service trade-offs are developed.
- An industrywide profit squeeze forces rapid cost cutting, particularly through staff reductions.
- Capital requirements increase while access to capital markets is reduced.

Don Waite's point--and I agree--is that the processes and impacts of banking deregulation can be expected to produce similar results. In fact, many of these impacts are already being felt in banking.

How do these results of deregulation in other industries relate to banking? In particular, how will deregulation affect different kinds of banks such as the money center banks, the regional banks, and the community banks? How will each type of bank respond to the changes that will accompany deregulation?

First, what can we reasonably expect as a response by the money center banks? As you know, large money center banks have been the primary champions of the removal of prohibitions against interest rate ceilings and interstate banking. These banks have

led the charge for deregulation largely because their unregulated nonbank competition has become fierce. Furthermore, large banks seem to be adopting a supermarket approach to providing financial services. We have already seen Bank of America and Security Pacific attempting entry into the discount brokerage business. In addition, Chemical New York Corp. is trying to buy an interest in Florida National Banks in an effort to diversify its markets, and First Interstate Bancorp is planning to franchise its name and services nationwide.

In addition, these big banks are targeting broader nontraditional markets. For example, many are moving more aggressively to serve the middle market--those companies with annual sales of \$5 million to \$100 million, by cutting lending margins while financing such activities by raising funds in the commercial paper market. In another case, Continental Illinois has formed a new subsidiary which tailors financing deals with smaller companies which can't qualify for conventional lending. Continental takes an equity position in overriding royalties, warrants, or stocks of these companies. This is an approach previously dominated by regional banks.

Thus, in my view, as these large banks push forward to capture a greater share of the middle markets, they will need to either expand geographically to become dispersed supermarkets, or they will need to concentrate into a somewhat narrower product or customer segment of the market in order to survive. Experience with deregulation in other industries suggests that few survive

in the supermarket mode without first counting the capital cost requirements and properly assessing other competitive forces in the market.

Turning to a second banking segment, what developments might we expect among regional banks as a result of deregulation? Consistent with the impacts of recent deregulation in other industries, a number of mergers among regional banks would likely occur, although few may produce the desired results. The recently announced merger of two Pennsylvania regionals, Pittsburgh National Corp. and Provident National Corp. of Philadelphia, illustrates this strategy. These regional banks however, will generally not, in my view, be able to transform themselves into financial supermarkets capable of competing with money center banks across the board. In fact, I would anticipate that many regional banks will likely lose an increasing share of their national commercial accounts to the money center banks, because regionals may be unable to offer the full range of services available at very large banks and nonbanks. Moreover, the correspondent banking network, which has been a cornerstone of U.S. banking for years, will be weakened through the loss of some of these commercial accounts to upstream money center banks. In addition, I suspect that the regional banks will probably lose some customers to the nonbank institutions who will be courting the regionals' downstream respondents.

In fact, some observers feel that the regional banks will be most vulnerable to erosion of their customer and service bases as

a result of deregulation. This would be particularly true in attractive, growing markets such as Houston and Denver where money center banks and nonbank financial institutions will push more aggressively.

Although regional banks may be under tremendous competitive pressure, these banks will not be without options. And some will emerge as winners. I believe that two of the characteristics of regional bank winners in this competitive battle will be those with narrow, simple product lines requiring minimal service and those which select a market segment and target attractive products and markets. For instance, Mercantile Texas, in Dallas, has specialized in the development of data processing services that have produced strong service income.

In Nebraska, the larger Omaha and Lincoln banks may no longer be "full service" institutions with all that implies. Such banks may choose to become a low-cost producer of financial services. But because of large structural costs, such a strategy may be difficult to achieve. As the bankers in Omaha and Lincoln know, it is extremely difficult to compete on price with money market funds or loan production offices of large city banks which do not have the same overhead and other fixed costs of doing business. One real possibility I see in a fully deregulated environment is that larger Omaha and Lincoln banks could assume a brokerage role for the financial products of money center banks and nonbank firms. Another alternative for banks may be to specialize in those products and markets which are not highly

price sensitive. But this requires, in most cases, a sharp retrenchment and perhaps a contraction of the customer base.

While these ideas may be particularly uncomfortable for regional bankers, and perhaps subject to overstatement, the experience of deregulation in other industries does lend support to their basic thrust.

To this point, I have limited my comments to the potential impacts of deregulation on the money center banks and on the regional banks. The third and final segment of banking which I want to talk about today--community banks--includes most of you in this gathering. In one sense, I have saved the best for last. I say this because if the nation's experience with deregulation is a reliable guide--and I tend to think that it is--then community bankers have the least to fear from banking deregulation. However, there are still many aspects of deregulation which will affect community banks.

One of these is related to the concerns you have that deregulation will spawn new competitors right in your own markets. While that is a legitimate concern, you should not lose sight of the practical realities of marketing financial services. Nor should you discount your own solid strength in your communities.

Of course money center and regional banks are seeking lucrative new markets with strong growth, broad business potential, and high income levels. But many smaller towns and cities don't meet these criteria. Thus, one advantage of the community bank may be that the territory may not be directly accessible to the

larger banks except by way of acquisition. And it is important to remember that the power of your personal contact banking-- particularly on the lending side--is a formidable barrier to any potential outside competitors. Thus, deregulation will affect the community banker mostly in the challenge of providing new financial services, not in the impact upon the customer base.

Given the community bank's strength, based on knowledge of, and service to, the community market, what else can be said about the likely results of deregulation on these banks? In my view, the community bank will become more of a retail distribution point for financial services. However, these services may no longer flow merely from correspondent relationships, but also, perhaps, from sources like Merrill Lynch and Shearson-American Express. By the way, while these institutions are presently tough competitors for your customers' money market investments, these firms will lose most of their advantage after interest rate deregulation. As always, price competition will give way to breadth and quality of service. Given the evidence of strong management we see in most community banks, I, for one, am confident that the community banker has the skill to develop and market the appropriate mix of new and traditional services for his customers and, in so doing, protect his deposit base.

This question of the deposit base for community banks is certainly a concern related to deregulation. But there is interesting evidence on this point. A recent study discovered that people who live in towns of under 50,000 population tend to

concentrate their banking relationships to a greater degree than those who live in larger cities. The same research indicates that families in smaller towns use savings and loans less. However, in Nebraska, you are well aware of the sizable market presence of the thrifts. Nevertheless, reality dictates that the thrifts, much more than banks, will be required to adjust the nature of their business in response to deregulation. Because of the weakened capital positions and thin managerial resources for conducting a banking-type business, many thrifts will face huge problems developing a full range of competitive services during the transition period. In my view, commercial banks will have a definite competitive edge as thrifts seek to become more like banks.

Among other possible deregulation developments which could impact the community banker is the removal of the McFadden Act, thereby allowing nationwide banking. Although a somewhat remote possibility, nationwide branching would spur interest in the rapidly developing growth markets. However, a cost-benefit analysis, particularly where the incumbent bank is well capitalized with little leverage, would probably show surprisingly few good prospective markets for branching. Again, most community banks' dominance in their own markets would likely deflect branching incursions.

In addition to the community bank's ability to prosper and withstand challenges in a deregulated environment, there is one additional strength of a community bank which contributes

very importantly to its pre-eminence. That strength, of course, is its strong capital position. A community bank's capital not only bolsters the very existence of the bank and assures its staying power in any environment, but that capital contributes importantly to public confidence in banks relative to their nonbank competitors.

For all these reasons, therefore, I believe that community banks, among banking's three major segments, have probably the least to fear from deregulation. Community banks are best equipped, because of their geography, their strong management, their style of doing business, and their capital strength, to deal with new competitive forces in their markets.

As a central banker, I have intended today to give you my views of some of the possible implications of deregulation for the banking industry. You may feel that I have exhibited the same foresight as those misguided football teams who think they are going to beat Nebraska each year. It just doesn't happen very often. However, if the final deregulation scenario is anything like the one I have pictured, the implications for you are striking. But rather than being the cause for great anxiety and discomfort, deregulation is, in my judgement, presenting Nebraska bankers with a broad array of opportunities. Your challenge is to devise the strategies which permit you to take advantage of those new opportunities as they occur.