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Comments on Deregulation

*Howard*

Scope of Deregulation

Definitions & Concepts:

1. Interest Rate Deregulation - Removal of Regulation Q restrictions is nearly complete. March 31, 1986 all interest rate ceilings should be removed.
2. Product -
  - (a) Permitting banks to offer a wider variety of financial products & services.
  - (b) Reducing or eliminating the restrictions separating banking and commerce.
3. Geographic - Permitting Interstate Banking
  - (a) States permitting entry under The Douglas Amendment of the BHC Act.
  - (b) Congress repealing Douglas permitting nationwide interstate banking.

Principles of Analysis

As Paul Volcker has stated - the Federal Reserve wants a competitive and innovative banking system, providing services to customers both economically and efficiently. The movement to meet these objectives for the banking system, and for that matter all depository institutions, however, must be cognizant of their special and critical role in the economy -

1. As operators of the payment system.
2. Custodian of the bulk of liquid savings.
3. Unbiased suppliers of short term credit. ✓
4. Link between monetary policy & the economy.

Such a unique and critical role suggests that there will be continued regulation working to assure a deposit and credit system that is:

1. Impartial
2. Stable
3. Competitive

1. Glass-Steagall act
2. McFadden act.
3. Douglas Amendment to BHC act.

Product Deregulation

A. Kinds of Product Deregulation

1. BHC Product Expansion

- (a) Securities activities
- (b) Sponsoring mutual funds
- (c) Insurance activities
- (d) Real estate

*Discount mortgage  
and underwriting Revenue bonds.*

*broking & underwriting  
development & equity ownership*

2. Nonbank firms as depositories of consumer deposits

A. Definition of a bank and the entry of major nonbank firms into banking.

B. Elimination of Glass-Steagall - *separation of investment banking and commercial banking*

B. Advantages of Product Deregulation

- 1. More potential competition in meeting the investment, credit and savings needs of consumers.
- 2. Broader and more diversified earning base for institutions.

C. Concerns with Product Deregulation

1. Potential loss of impartiality and increased risk in banking.

(a) The separation of banking and commerce serves to assure an impartial provision of financial services. It minimizes the use of bank credits to support affiliated nonbank commercial activities, underwriting activities, and the problems that arise when cross industry affiliations are permitted.

(b) It is difficult to determine the precise need for this separation, but instances of resulting problems when this principle is violated have been documented.

(1) Baldwin-United. This one time piano company acquired banks, savings and loans, insurance companies and a host of other financial and commercial businesses.

Baldwin-United was required to divest of its impermissible nonbank activities or banking activities by year-end 1980, by virtue of becoming a bank holding company under the 1970 Amendments to the Bank Holding Act. The Board of Governors approved its plan to divest of its banks July 30, 1980. Saddled with high interest cost and negative carrying costs on many of its assets, Baldwin's future became uncertain. In September 1983, Baldwin filed for bankruptcy. It remains uncertain how much money customers

holding annuity plans purchased from Baldwin's insurance subsidiaries will recover. Elsewhere, its former banking subsidiaries continue to operate at a level of performance hard to imagine if they had continued under Baldwin control.

- (2) Real Estate Investment Trust - In the early 70's BHCs set up or became part of a real estate advisor to Real Estate Investment Trust. Difficulties arose in 1974 when economy and especially the construction industry slumped and the trusts began to have financial difficulty. To protect their reputations and the integrity of their company names, many BHC advisors felt compelled to have their banking subsidiaries extend loans or purchase assets from the trusts to see the trusts through their problems. For instance, Chase Manhattan Bank purchased \$160 million of Chase Manhattan Mortgage & Realty Trust loans, giving the REIT a note. Of those loans, approximately \$86 million were non-income producing at the time. Yet, the bank continued to pay full interest to the trust on its loan balance. Such actions tended only to extend the problems to the bank.

*160 m  
86 m non performing*

Conclusion:

Product deregulation, consistent with the principles of safety and soundness and unbiased and consistent credit markets, is needed. But unrestricted, full interindustry integration has a price and risk that suggest it should be pursued carefully.

Geographic Deregulation

A. Kinds of Geographic Deregulation currently taking place

1. State - individual states act to permit entry by out of state banking organizations.
2. Regional zones - states acting together to permit interstate banking among participants in the zone but to the exclusion of others not party to the regional compact.

B. Factors Favoring Interstate Banking

1. De Factor interstate banking is here - Through 7,400 interstate offices, larger banking organizations are providing many banking services. In fact, 1,500 of those offices are providing full banking services. Further, many nonbank firms, not constrained by geographic restrictions, are providing many "bank-like" services on an interstate basis.

*Banks Just in Florida - Nonbank bank.  
Deposits - Consumer loans.*

2. Much of the interstate movement has proceeded in cumbersome and inefficient ways as banking organizations find ways to circumvent laws which were intended to limit their geographic reach. A rational, consistent program for interstate bank is preferable to the current movement.

C. Concerns with Geographic Deregulation

1. Concentration of banking resources - Currently, four largest banking organizations control 10 percent of U.S. bank deposits. Interstate banking may cause national concentration levels to rise. It would be a serious error to let this occur without analyzing the impact on regional and national markets or determining whether current antitrust tools sufficiently protect banking competition.
2. Efficiency of operation as a justification for larger interstate operations hasn't been proven.
  - a. Studies are unclear. It appears that there are few economies of scale in banking. Big banks don't appear to have much cost advantage over small banks.
  - b. Unclear that small institutions can't provide low cost sophisticated services through alternative arrangements as end point sellers, e.g. franchising.
3. Financial stability - As interstate banking proceeds and institutions grow in size and importance their significance to the stability of the payments mechanism increases. This may lead to a greater need for regulatory oversight and less freedom for these institutions to make mistakes. *(daylight overdrafts)*

D. Regional Interstate Zones

1. Represent a step along the way to public recognition of interstate banking on a nationwide basis.
2. It provides an opportunity for institutions within the zone to develop a base sufficient to compete with large institutions outside the zone.
3. It provides a testing ground to determine the extent concentration may rise and the ability of antitrust tools to deal with this rise if it impacts banking market competition.

Conclusion

Some form of interstate banking is inevitable. Whether it should continue on a regional, more experimented basis, or on a national basis seems to be the more immediate issue requiring resolution.