The Structure of Our Changing Banking Industry: Let the Market Decide

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The United States is now thoroughly committed to historic change in the regulation of its banking industry. In our nation's 19th century vision for the banking industry, reinforced by legislative changes in the 1930s, government regulation severely constrained the geographic location of each bank's offices and the services it was permitted to provide its customers. Each bank could maintain offices for accepting deposits in only one state, and in some states in only one county. Unit banking states permitted each bank to maintain only one office. Banks could offer traditional banking services, including deposits and loans, but little more. Insurance services were banned, and securities underwriting was severely limited. Clearly, law and administrative regulation have been critical in determining banking structure in the United States.

When I talk of "banking structure" I intend a very broad definition of industry characteristics, including the geographic spread of offices, the financial products offered and the organizational forms of banking enterprises. It is not an exaggeration to say that historically the banking industry has been one of the most comprehensively regulated industries in the country. Financial services, however, are inherently a pretty competitive business: Many different types of financial firms, and the public securities markets, offer overlapping products, and many of the overlaps are so close that the products are functionally identical or nearly so. Especially over the last quarter century, the markets have been deregulating themselves. Commercial banks, as the most tightly regulated of all financial firms, have often found themselves at a competitive disadvantage in an increasingly diverse and innovative marketplace. It is not surprising that bankers often feel overregulated and under-loved.

I agree that banks are overregulated. As for bankers being under-loved, well I probably can't do much about that. I am reminded of a summer job I had during graduate school at a bank in Wilmington, Delaware, where I grew up. One of the guys I ate lunch with worked in the auto loan department and was responsible for repossessing cars. He wandered around neighborhoods at night looking for the cars he had to find, and with his fistful of keys could drive right off. He had some frightening tales, including some of being shot at. Perhaps after my speech you can give me some good ideas about how I can persuade the public to love the banker who's repossessing its cars! Actually, the problem is pretty simple—you bankers just need to learn how to lend money without ever having to try hard to collect it!

Anyway, I do want to discuss my views on where we ought to be headed with banking regulation. A sensible discussion requires some background on how we got to where we are, and what regulations ought to remain. That's my first major theme.

My second major theme concerns the probable future environment for community banks. My punch line is simple: I believe that community banks will continue to play an important role in the U.S. economy. I can't offer a guarantee, but I can offer my best guess that large banks and community banks will compete side by side in many markets, and that community banks will be every bit as profitable as large banks. I simply cannot believe that community banks are a dying breed when Missouri granted 15 new bank charters over the last three years.

Before I get any further along, let me emphasize that the views I express here are my own; these regulatory issues are complicated and controversial, and I am not the one to announce official policies of the Federal Reserve System. What I will do is present my views on trends in banking and desirable changes in regulation that would give market forces greater freedom to shape the industry.

THE 19TH CENTURY REGULATORY VISION

The 19th century vision for banking was based on some basic ideas about the role of banks in society and the conditions necessary for maintaining a safe and sound banking system. Experience, particularly the trauma of banking panics and failures in the 1930s and the Great Depression, also shaped banking regulation. Many of the ideas that supported this 19th century vision have been discredited, and much of these prior regulatory arrangements has been abandoned. But we still have more regulatory heritage—regulatory baggage, I think—than we need.

One objective of government policy on banking structure has been to limit the power of large financial institutions. Throughout the history of the United States, government policy has been shaped by a fear that large financial institutions would exercise excessive economic and political power. Public policy limited the growth of banks through restrictions on entry, branching and mergers.

Another objective has been to promote lending to small businesses. Our banking regulations reflect a concern that if market forces determined banking structure, large banking organizations would attract deposits at offices located throughout the nation and lend these funds in financial centers. Local businesses, so the argument went, would be starved of the credit they needed to prosper. People in communities throughout the nation viewed branching by large banking organizations as a threat to the economic health of their local economies. An objective of government regulation of bank structure was to create a banking industry composed largely of small banks that would lend to small businesses located in their communities.

The government also attempted to make banks safe by restricting competition among banks. Government restricted entry into banking in the early 1930s in an effort to limit the number of bank failures. Under this policy, government agencies often denied applications for charters because new banks might have adverse effects on the profits of existing banks located in their same communities, undermining their viability. The government also attempted to restrict competition among banks through ceiling interest rates on deposits, including a ceiling rate of zero on demand deposits.

Government has limited the services offered by banks and the types of firms with which banks affiliated to limit the possibility that losses on loans and investments would cause banks to fail. For instance, reducing the risk of bank failure was one of the objectives of the federal government in separating investment and commercial banking in the 1930s.

The role of the government in regulating the banking industry in the past reflects the policymakers' understanding of banking, and the balance of political forces in our federal and state legislatures, at the time regulations were imposed. However, it is important to recognize that tremendous intellectual development in the understanding of banking has taken place in recent decades. Astute observers, both academics and practitioners, believe that many of the propositions justifying regulation historically are false. Consider the restrictions the government imposed on bank competition in the 1930s. Economists today generally agree that the large number of bank failures in the 1930s did not result from excessive competition. Research has undermined the view that restrictions on competition are necessary to preserve the stability of the banking industry. In addition, research has not supported the argument that the securities underwriting activities of banking organizations caused bank failures and the Great Depression.

Government regulation of banking structure has been relaxed substantially since World War II. Nevertheless, the recent federal law that mandated nationwide interstate banking has some features that reflect the history of public policy in shaping banking structure. This legislation, enacted in 1994, requires banking organizations with offices in more than one state to meet standards for lending funds in the states where they attract deposits. This provision reflects a fear that large branch banks will starve small businesses of credit by using deposits received through their branches to lend in financial centers. In addition, this legislation sets limits on the shares of banking deposits that can be controlled by any one organization in a state and in the nation. These limits reflect the fear of a concentration of financial power. Thus, ideas that shaped our 19th century vision of bank regulation continue to shape banking legislation today.

THE NEW VISION

If we have abandoned the 19th century vision of banking, if not all its residue, where are we headed? What is the new vision for the role of banks in society? Does the government continue to have compelling reasons to support banking services with deposit insurance and other elements of the financial safety net for the banking industry? Will the encroachment of nonbanking firms into the activities of banks continue until there is no clear distinction between banks and other providers of financial services? Do community banks have an important role in the financial system in the future? If we want to preserve an important role for community banks, do we need to establish new barriers to competition from larger banks and from other providers of financial services? To discuss these issues, we must consider bank regulation as a whole, rather than focus separately on the parts implemented by the Federal Reserve or other bank regulatory authorities.

I do not have a detailed blueprint for the future or a specific proposal to promote. I do have some basic principles that shape my thinking about these issues, however, and these principles lead me to some conclusions.

The first principle is that the government continues to have a compelling reason to support banking services with deposit insurance and other elements of the financial safety net. This principle is based on the fact that banks serve two important purposes in our economy: They provide credit to borrowers who do not have direct access to credit in the securities markets and, even more importantly, they process payment orders for their depositors. Experience indicates that major disruptions in these lending and payments functions cause disruptions in economic activity.

The second principle is that, while maintaining deposit insurance and the financial safety net for banks, we should rely on market forces rather than regulation as much as possible to shape the structure of the banking industry. Attempts to preserve the roles of particular types of banks, like community banks, through regulation would not be in the public interest. Such regulations would interfere with the public's ability to freely choose its providers of financial services, and in our highly competitive economy, would eventually be self-defeating for banks themselves.

Why do I say "self-defeating?" Consider the example of the prohibition of interest on demand deposits and Regulation Q interest rate ceilings. Bankers welcomed these regulations when they were introduced in the 1930s, because interest-rate constraints held down the cost of funds to banks. But when Reg. Q ceilings were extended to thrifts in the 1960s, ceiling rates were set higher for thrifts than for banks, leaving banks at a competitive disadvantage. And in the 1970s, both banks and thrifts were at a disadvantage relative to money market mutual funds, which could offer rates on checkable accounts without regulatory constraint. In a rapidly changing marketplace, Regulation Q became a regulatory albatross instead of a regulatory protection for banks.

The biggest challenge in reconciling the safety net for banking services and market forces involves the powers of banks and the encroachment of nonbank providers of financial services on the turf of banks. One way the government might respond to this encroachment would be to extend bank supervision, regulation and the financial safety net to these nonbank firms. If lending and the operation of the payments system are important in maintaining a stable economy, why limit supervision and regulation and the safety net to banks? Why not treat all firms that lend or provide any payments services as banks?

Although there is a certain logic to the call for extending government regulation over all financial firms, I am convinced that doing so would be highly undesirable for several reasons. First, the government's commitment to support the banking system through deposit insurance would be extended to a larger share of the private sector, and the government would expand its role as supervisor and regulator. Government guarantees would become vastly larger than they are today, as would the risks to the taxpayer. Second, given the intimate connections between financial and nonfinancial activities in our enterprise system, we would risk never-ending extensions of government control far beyond financial activities per se.

Another approach to reforming bank regulation would involve narrowing the safety net by placing greater restrictions on the types of services that banks may offer, and tighter restrictions on the risk that banks may assume. This approach, I am convinced, is not a viable option over the long run because of competition from nonbank firms. Banks subject to continuing tight government regulation would lose their share of the business to nonbank competitors. In time, the most important lenders and providers of payments services would operate beyond the jurisdiction of government supervisors, leaving the economy vulnerable to the types of shocks that led to the development of our system of bank supervision and regulation and the safety net in the first place.

I believe that we can avoid either of these undesirable outcomes by maintaining government supervision and regulation and the safety net for banks, while giving market forces a greater role in shaping the structure of the banking industry. If government policies are consistent with the basic objective of maintaining financial stability, we can rely on market forces to shape the structure of the banking industry in a way that is efficient and socially desirable. The topic that requires the greatest thought is regulation of bank powers and the affiliation of banks with nonbank firms. I suspect that we will be living with uneasy compromises on this matter for a long time. Quite frankly, if I had a brilliant solution, I'd love to offer it. But I don't.

THE SHAPE OF OUR FUTURE BANKING STRUCTURE

I'll now turn to some remarks on the likely direction of banking markets in the future. I do not believe that community banks will need special protection in order to thrive. Experience indicates that community banks can and do operate successfully in the same geographic markets, and in many of the same product markets, as much larger banking organizations. Community banks have some important advantages, including opportunities for their customers to have personal relationships with top decision-makers, and ability to compete without the challenge of coordinating the activities of large numbers of employees.

While we do not yet have a complete blueprint for a new vision for banking regulation, and therefore do not have a firm idea about how regulation will shape the future of banking, we can gain some valuable insight into the forces that shape the banking industry by examining how regulation and market forces shaped the banking industry in the past. If we go back to the period before 1980, the banking industry of many states consisted of many small banks, each with one or at most a few offices. There were a few relatively large banks, though they would not be considered large by today's standards.

Although regulations have been a major force shaping the structure of the banking industry, they have not been uniform across states or over time, and we can use that fact to provide insight into the industry structure that will emerge as market forces play an increasingly greater role in shaping the banking industry.

Missouri, historically a unit-banking state, had a total of 497 banking organizations in 1980, and the five largest accounted for 45 percent of assets. But in a banking industry shaped primarily by market forces, would the large banks drive all of the relatively small banks out of business? We know that a lot of consolidation would take place; it already has. The issue is whether all community banks would be forced to consolidate. The best evidence we have on this question is the experience in states that have permitted statewide branching for many years. Consider four of the states that permitted statewide branching prior to 1980: two in the West (California and Idaho) and two in the East (Maryland and North Carolina). The average share of banking assets at the five largest banking organizations in these states in 1980 was 74 percent. How many banking organizations operated in these states in 1980? Here are the numbers:

- California 291
- Idaho 25
- Maryland 87
- North Carolina 79

These figures indicate that many community banks operated in the same markets as banks with far-flung branch systems.

Why do community banks do so well? You know the answers better than I do. Some customers prefer small banks because they have personal relationships with top decision-makers in such banks, whereas it would not be possible for them to have relationships with the top decision-makers at larger banks. Relatively small banks may be more efficient than larger banks in delivering some services. Small banks are likely to have closer ties to their communities, yielding advantages in assessing credit risk. Of course, only large banks with large amounts of capital can make the large loans required by some borrowers, but that fact does not mean that huge banks will be more efficient than small banks in making large numbers of individually small loans.

Allowing market forces to shape the banking industry will not be the end of the community bank. This examination of banking structure in the past indicates, lifting constraints on the operation of market forces leads to the emergence of large banking organizations with many branches but does not eliminate the relatively small community bank.

A PROGRAM FOR LETTING MARKET FORCES SHAPE THE BANKING INDUSTRY

How would we implement a policy of letting market forces shape the structure of the banking industry? Because of the importance of entry into an industry for determining its structure, the best place to begin this discussion is with the granting of charters. Under deposit insurance and other elements of the financial safety net for the banking industry, it is reasonable for the government to set standards for granting charters. These standards include checks on the backgrounds of bank organizers, to prevent granting charters to criminals. These standards also require a minimum level of capital for new banks. Under my approach of letting the market decide, these would be the only standards for granting charters. All applicants who qualify would receive charters.

The government would permit banks to open branches anywhere they want. Government agencies, including the Fed, would approve banking mergers and acquisitions unless they reduced competition or the financial strength of the banks involved in the mergers and acquisitions. As long as new organizations were relatively free to enter into banking, most mergers could be permitted without concern that banks could gain market power through mergers.

Finally, limits on the percentage of deposits in a state or in the nation held with any one bank are inconsistent with letting market forces shape banking structure. We do not need to limit the market power of banks through such regulations. Competition is a more effective tool for limiting such power. Any bank that attempted to raise interest rates on loans, raise service charges or reduce the interest rates it pays on deposits would lose business to its competitors. I would eliminate the limits on the percentage of deposits at any one bank as unnecessary and undesirable limits on the freedom of market forces to shape the banking industry. This program for letting the market decide would not have adverse effects on the safety and soundness of the banking system provided that regulators enforce effective capital requirements, as is necessary to sustain the deposit insurance system.

My bottom line is simple. Small firms are prospering across the entire U.S. industrial landscape. In only a handful of industries are large firms increasing their market share because of compelling economies of scale. Banking is no different in this respect from the typical U.S. industry. Although large banks are growing as artificial branching and line-of-business restrictions are swept away, small banks are prospering when they are well managed and when they select the proper market niches. A banker's life is certainly more intense than it used to be in the old, highly regulated days, but the rewards for entrepreneurial bankers and their customers are to be celebrated rather than bemoaned. I for one am only too happy to break out the champagne!

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