



"DEREGULATION: THE CHALLENGE TO
BANK MANAGEMENT"

Address by
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I am very pleased to have this opportunity to speak to the Bank Management Association, representing as you do the management of banks in the greater St. Louis area.

Although I am a relative newcomer to St. Louis, this is sort of a "homecoming" to me, since I have just completed a series of meetings with financial institutions throughout the 8th Federal Reserve District, which I find covers a lot of ground. The purpose of those meetings was to get acquainted with my new constituency, to provide information about our policies and services, and to listen to suggestions for improving our performance. The results have been gratifying, and the response from those attending has been encouraging. I believe some of you were present at our meeting here in St. Louis.

As a commercial banker for almost thirty years, and a Fed president for only a few months, I am still more at home with bankers than my new associates in the Federal Reserve System. I like bankers, and find it easy to communicate with you. I hope you will keep in mind that there is someone over at the Fed who understands your problems, talks your language, and wants to maintain an open line of communication with you -- whether to hear your constructive suggestions or legitimate complaints.

Of course, I have my philosophical biases, derived in part no doubt from a long exposure to the "Chicago School" of economics. Stated simply, they are:

- 1) the least regulation required to protect the public interest is the best regulation, and
- 2) the free market is the most efficient method of rationing scarce resources in our economy.

With that on the table, let's turn to my promised subject -- the challenge posed to bank management by deregulation of financial institutions. In a way, this topic reminds me of the old adage that when a man knows he's going to be hanged, it concentrates his mind wonderfully. Although much has been said about deregulation, it still seems to concentrate a bank manager's mind wonderfully. Maybe that's because unless he can figure out why it came about, where it's going, and what he does about it, it will become a hangman's noose for his bank.

If any of you are old enough to have experienced the terrible times of the early thirties in banking, you know that most of the laws, regulations, and regulatory structure governing banks came out of that economic crisis when the overriding consideration was preservation of the nation's payments system. With a focus on bank safety, regulations have always served to create barriers to competition. This takes the form of restrictions on entry, limitations on locations, ceilings on interest rates that may be paid on deposits or charged on loans, and restrictions on permissible activities.

However, as Robert Frost has noted, "something there is that doesn't love a wall, that wants to tear it down." Certainly the walls that regulated banking don't exist any more. Tidal waves of financial innovations have overwhelmed the regulators and regulated alike; while many of the old laws are still in place, the walls they were intended to create have long since crumbled. How did this happen?

The accelerating inflation of the seventies brought much higher interest rates than had been known since the twenties. As market interest rates climbed through deposit ceilings, "disintermediation"

became widespread. It was one thing for a savings depositor to ignore a small premium rate over what he was paid by his bank when inflation was nominal, but quite another situation when inflation had soared to double digits and market interest rates were more than twice his return on a regulated bank deposit. You might say depositor self-preservation was the driving force behind his move to marketable securities and money market mutual funds.

Naturally, banks and other depository financial institutions had to obtain relief from regulated interest ceilings to survive. The evidence can be found in everything from T-Bill Certificates and NOW accounts to the newest Money Market Deposit Accounts. Not only have banks found a way to pay market interest rates, but they are even paying them on checking accounts! So much for deposit interest rate ceilings. With some important assistance from the federal level and some heavy battles on the home front, usury ceilings on loan interest have also been generally eased or eliminated.

Only a few years ago, it was inconceivable that banks could branch across state lines. Out-of-state and foreign banks were (to paraphrase Mark Twain) as out of place as a Presbyterian in Purgatory. Now, Presbyterians are popping up everywhere. Citicorp and Security Pacific are buying banks in South Dakota; Bank of Boston is acquiring one in Maine; Rainier is moving into Alaska; Bank of America has a deal set to take over the largest bank in Washington; Morgan, Chase, Manufacturers Hanover and others are establishing banks in Delaware, which is fast becoming our "Little Switzerland" in the United States. Northern Trust and NCB have capitalized on a grandfather clause in the Florida banking

law to enter banking in that state. Chemical has an option to purchase a large Florida bank "when permissible." Add to these illustrations, the nationwide proliferation of loan production offices, subsidiaries for (among other things) leasing, mortgage banking, consumer loans, commercial finance, investment counseling, discount brokerage, data processing, futures commission merchant, international banking, and export trading, and you can see that the walls intended to contain geographical expansion and permissible activities are more like a sieve.

Furthermore, until recently only depository institutions could engage in "banking" activities. Now the lines between banks, thrifts, and financial service firms have become so blurred that most customers find it difficult to distinguish the differences any more. A case in point would be Merrill-Lynch's cash management account, which offers customers a securities margin account, an interest-paying money market mutual fund (with checking privileges), and a charge card with a line of credit. An innovative management, together with advancing computer and communications technology, made this attractive consumer product possible.

Concurrently, an amalgamation of financial service firms and some non-financial companies is taking place. Insurance companies (such as Prudential) are buying banks in order for their investment brokerage subsidiaries to have I.R.A. and other "deposit products" to retail nationally through their branch system. Incidentally, in case you need a national branch system, I saw a Merrill-Lynch ad recently which said they had placed \$5 billion of bank and S&L CD's with individual investors in the last year. In a variation on the theme, Merrill Lynch is buying a savings and loan association. Citicorp and National Steel are already

there -- they own savings and loans with statewide branching powers in California that are expected to spread their retail deposit gathering system nationwide in time. We mustn't forget Sears and Penney. The former owns a California savings and loan, a large investment banking and brokerage company, a big mortgage banking and real estate brokerage operation--not to mention a major insurance company. A recent WSJ carried a story about the Sears annual meeting in which they announced a plan to buy a bank or more S&L's, offer a line of credit secured by home equity, and develop a national network of ATM's for their 40 million charge card holders, enter home banking, and develop a national payment system for financial institutions. Penney just agreed to acquire a Delaware bank and has also announced plans to enter the home banking market. On another front, money management firms such as Dreyfus Corporation have discovered a way to make a "non-bank" out of a bank by limiting its function to deposit taking with no commercial loans. American Express is putting cash machines in place across the country to be activated by a debit card.

Clearly, the regulatory walls intended to contain banking prices, restrict geographical presence, and limit entry to supervised participants are tumbling down. Like Humpty Dumpty, I doubt that they can ever be put back together again. The question in my mind is whether all this is truly in the public interest. I think we may be experiencing a distorting effect here of the interaction of old laws and regulations, and the innovative techniques made possible by modern technology for circumventing them.

Is it really desirable to have deposit-like instruments spring up overnight to hold \$200 billion of personal financial assets without the protection of federal deposit insurance or supervision? Are we possibly dooming our traditional banking system by requiring it to maintain minimum capital, while new forms of banking with no such standards develop outside the system? Is it really in the public interest to allow individual states to determine which services banks will be able to offer on a nationwide basis, even when in direct conflict with established federal policy?

The conclusion that I draw from all this is that it is high time for a critical review of existing federal policies as reflected in our banking laws, in order to determine what the public interest really is. Are we getting too far from safety and soundness with respect to liquid savings? Could we possibly be jeopardizing the viability of the payments system by permitting it to shift away from banks? Do we really want a merging of financial and non-financial businesses in this country? Is the risk of economic concentration being properly considered?

Meanwhile, how do you as managers of banks cope with the de facto situation of a deregulating banking system? It may be constructive to look at two other major industries that have been subject to substantial deregulation in recent years: securities firms and airlines. In those industries, we saw that deregulation resulted in weak firms becoming weaker much faster than strong firms got stronger. The most profitable products came under severe price pressure as competition focused on them. There was an industry-wide profit squeeze that forced rapid cost-cutting, particularly staff reductions. This impacted both large and small firms as competition intensified from new entrants.

In the brokerage business, the public has turned increasingly to discount brokers who offer to execute transactions at cut-rate prices. Without the overhead of "full-service" companies, this leaves them room for profit while making the established companies unprofitable in this line of business. Incidentally, banks are the principal new entrants to this business currently.

The airline industry provides additional evidence for the gains that deregulation provides. Not only is flying generally much cheaper than it would otherwise have been, there is considerably more competition in the industry. Prior to the recent deregulation, virtually no new airline had been chartered for about 40 years, and route competition among existing airlines was severely restricted; since deregulation, more than 30 new airlines have appeared. Moreover, competition in the major markets has widened considerably as existing airlines have moved in to compete head-to-head. Of course, competition has been reduced in some of the lesser markets lacking profit potential, and prices have risen there while service has been limited. No wonder we hear concern in the banking business about an equivalent of the \$99 coast-to-coast fare.

But, what of the consequences of deregulation on the financial institutions themselves? What can you do about deregulation? Well, first of all, you might consider re-regulating the industry, thereby attempting to turn back the calendar to a simpler era. Those who seriously think that this is a feasible option are much like generals who try to win the current war by fighting the last one over again. Old strategies and outmoded plans are unlikely to prevail. As some philosopher once noted, it is our future, not our past, that lays down the law of our today.

What about the airlines? You know what happened to Braniff and Laker, each of which was pursuing an independent strategy. Look at the earnings of the major airlines as a group; deregulation has not been especially kind to them. On the other hand, as I mentioned earlier, a large number of new firms have entered the industry and some of these are doing relatively well; it appears that they will survive.

In the face of ongoing deregulation, banks will continue to find themselves subject to continuing pressure on margins, greater earnings variability and excessive fixed capital (compared to their non-financial competitors). There will be greater divergence in earnings performances and further consolidation--both among banks and between banks and other financial and non-financial firms. There are now about 14,000 U.S. commercial banks. How many of them will survive? 10,000? 5,000? There is no way to come up with the definitive answer at this time. What is clear, however, is that there will be considerably fewer banks around when the competitive dust finally clears.

Which banks will survive? Analysis of deregulation in other industries suggests that there are three different types of banks that will survive. First, there will be those banks that will offer the full range of financial services worldwide; these will be the international distributors of financial services. It takes a lot of financial muscle to launch your own communications satellite as Citicorp has done. Second, there will be the "boutique" banks, those that specialize on specific financial services and markets that are not highly price sensitive. Here, one thinks of the "middle market" for business, the upscale market for retail, and the well-run community bank. Finally,

Second, you might try to slow down the impact of deregulation and give yourselves more time to adjust to it. The recent moratorium imposed on the further creation of "non-bank banks" is one example of such action. Certainly, such a period of "R and R" would be helpful if it is used creatively and if it could be guaranteed. The major problem with attempts to slow down the pace of innovation and market deregulation is that such pressures are not alleviated, they are merely shunted from one area to another. Unlike the boy who saved the dam by plugging a hole with his thumb, every hole in the regulatory dam that is plugged, even temporarily, will simply produce new holes. Even an octopus who was all thumbs would be ineffective under such conditions.

So what will deregulation do to banks? The final demise of price controls, product controls and geographical restrictions will affect banks in the same way that deregulation has affected every other industry. Again, we can look at the securities industry and the airlines to get a preview of what is in store for banks and other financial institutions as deregulation advances on all fronts. In the securities industry, there have been a number of firms that just disappeared; some went under and some merged with others to survive as commissions fell when the minimum commission structure was deregulated. Some have found it to their advantage to become associated with banks: Bank America Corp, Chase Manhattan, Citicorp, and Security Pacific are just the better known examples. A recent report estimates that there are some 600 depository institutions that offer some form of discount brokerage services.

some new, lower cost, banks will be successful simply because they are not burdened down by the major structural costs that tend to build up in regulated industries. These banks will focus on the highly price-sensitive segment of financial services.

Management of financial institutions will have to undertake a different attitude. Instead of attempting to deliver the best service at the lowest price in a narrow product line in some specifically prescribed geographical area, you will have to decide which services to offer and in which locations. In other words, the range of alternative options will increase very substantially and the number of decisions to be made will increase in geometric proportion to the options available. All of that, with a probably narrower spread between revenues and costs. While in the past managers of financial institutions were able to specialize in a relatively narrow line of endeavors, they will have to become much broader in their scope of knowledge and much more entrepreneurial in their actions.

In addition to understanding the traditional credit risks which derive from your lending function, you will need to understand that a risk almost as large has developed from the mismatch of asset and liability interest rate maturities in combination with much more volatile interest rates. You are going to have to know much more about marketing and how to make it effective, and you will have to accept the fact that talented people from outside your bank will be required for some parts of your business, producing some strain on traditional organization culture. Strategic planning, the essence of which is anticipation, will be the critical determinant of your success.

Although, many banks will disappear, I do not believe that this means that it will be the small institutions that will fail and the large ones that will prosper. Small institutions may excel in specific product lines and specific geographical areas. The failures will be dominated by those who make the wrong choices at the outset. Typically these will be institutions that attempt to blindly follow all actions of their competitors, that seek to provide services for which they have neither expertise nor experience, and that venture foolishly into localities and markets where they are unknown and likely to remain so. These failures will probably be equally distributed among the large and small institutions. On the other hand, those who make the right choices now and develop comparative advantage will be on a much stronger footing than they are now.

There is one final confusion that surrounds the issue of deregulation. Some people are concerned that deregulation is the same as "no regulations." This is clearly not the case. Financial institutions will continue to be subject to important and effective regulation. Financial institutions are different from other business firms in some very fundamental ways. Some financial institutions create money; that power affects everyone, not just the customers of the individual institutions. Control over this aspect must remain. Others provide the payments mechanism and the integrity of this mechanism must be protected.

Many regulations will therefore remain. Deregulation will remove only those that were standing in the way of increased efficiency in the provision of financial services. Also falling by the wayside will be regulations and restrictions that are no longer relevant to the new

competition that deregulation is fostering among financial services firms. A good example of this is the potential re-shaping of deposit insurance that is now taking place. Insured banks and thrifts pay the same insurance "premium" to obtain deposit insurance regardless of their own risk characteristics and circumstances. In the good old days, there may not have been a great difference between the riskiness associated with one bank and another. After all, banks were restricted to severely limited activities, and were generally protected from the vicissitudes of competition by the regulatory barriers surrounding them. But, no longer. As opportunities have opened up, competition has heated up, and, as interest spreads have narrowed, there has also been increased risk and greater divergence among banks in their asset and liability strategies. Some recognition of this will almost surely show up in deposit insurance rates for banks and thrifts. This is just one example of how deregulation will affect the remaining regulatory structure.

The fact that deregulation of financial services will provide great social benefits and greater overall efficiency doesn't make its impact on you, as bankers, any less difficult. The challenge you face is enormous. Yet it is no greater than that faced by any entrepreneur who has some resources, decides where and how to use them, and who bears the risks and rewards of his decisions. Indeed, the problem that you now face is similar to that of the two men who were hiking in the wilderness and found themselves suddenly face-to-face with an enraged grizzly bear. As the bear prepared to charge at them, one of the men quickly kicked off his hiking shoes and started to lace on some running shoes that he was

carrying in his pack. "You're crazy" the other man said, "you can't outrun that bear." "I don't have to outrun the bear," the first man replied, "I only have to outrun you."

Don't expect to outrun deregulation. To survive, you'll have to outrun your competition. If you haven't already done so, now would be a good time to start lacing up your running shoes.