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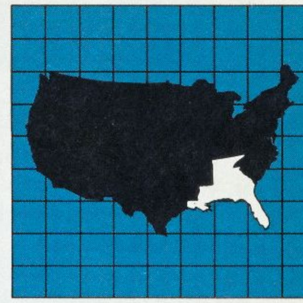
Economic Review



FEDERAL RESERVE BANK OF ATLANTA AUGUST 1981

SPECIAL ISSUE

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New Competition for Financial Services

Economic Review

FEDERAL RESERVE BANK OF ATLANTA

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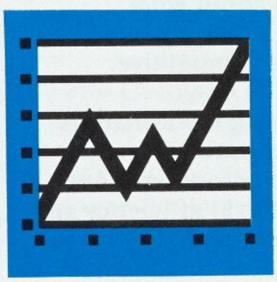
The Federal Reserve Bank of Atlanta has begun publishing ***Insight***, a newsletter on economic trends in the Southeast. ***Insight***, published twice a month and mailed first class, is designed to give readers fresh and timely data, analyses, and forecasts on the Southeast's economy. Free subscriptions are available from the Information Center, Federal Reserve Bank of Atlanta, P.O. Box 1731, Atlanta, Georgia 30301.

The purpose of the *Economic Review* is to inform the public about Federal Reserve policies and the economic environment and, in particular, to narrow the gap between specialists and concerned laymen.

New Competition for Financial Services



New Competition for Financial Services

Introduction

Spurred by inflation and deregulation, fundamental changes are occurring in the financial marketplace. The articles in this *Review* offer several perspectives about what these changes mean for suppliers of financial services and for their customers. Beyond that, the authors offer opinions about what questions need answering as we try to understand the new, more competitive, financial environment.

The common thread among the articles is the question of how regulators such as the Fed should view the new environment. Are the old assumptions about risk, efficiency and competition in financial markets being outmoded? These are clearly questions of interest far beyond regulators themselves, for regulatory attitudes will dramatically affect suppliers and users of financial services. The future is unusually exciting, but it is also murkier than usual.

To help us peer ahead, we invited five distinguished professors from universities within the Sixth Federal Reserve District to join us in an informal workshop earlier this year. Their perspectives and insights, together with two contributions from our own staff at the workshop, provide the basis for the articles that follow.

B. Frank King of the Atlanta Fed sets the stage by surveying the extent of recent deregulation and innovation in the context of conventional regulatory thinking. He notes that, "in their analyses, . . . banking agencies have treated commercial banks as offering a unique cluster of services in a market limited to local competitors." Yet the new environments cast doubt on all three assumptions:

(1) that banking services are offered *uniquely* by banks.
(2) that banks offer a characteristic *"cluster"* of such services, so that in analyzing competition, regulators can apply the number of competitors offering one service (deposits) to all services in the cluster.
(3) that such competition is generally *local,* so that analysis can be confined to local institutions.

There is "a need for evidence about the changing structure's impact on the performance of markets and institutions. It is needed not so much to convince the Supreme Court but to tell us how to analyze bank acquisitions and mergers, how to regard the expanding nonbank activities of bank holding companies, and whether to hasten or deflect the move toward interstate banking."

That the changes are, in fact, having a major impact in the Southeast is documented in the article by William N. Cox of the Atlanta Fed. Banks are no longer unique suppliers of financial services to households. Surveys by the Atlanta Fed show that Southeastern S&Ls are competing vigorously with banks for virtually the whole cluster of household financial services, Cox says, finding "little evidence that many thrifts see themselves sticking to their traditional product lines."

While the strength of S&L entry into the local competition is clear, the evidence raises several interesting questions: Why has the consumer move into NOW accounts been faster and larger than anticipated? Why do consumers seem to see bank NOWs and thrift NOWs as different products? Why is competition for some services in the traditional cluster more intense than for others?

With thrifts and others entering the local markets for household financial services, so that banks no longer offer them uniquely, are there any other financial products out of the old cluster which banks do supply uniquely in local markets? If there is such a product, it probably is loans to small businesses, since thrifts are still excluded. In legal terms, do loans to small businesses constitute a unique "line of commerce" for local banks?

This is an important consideration, because it may determine the extent to which thrift institutions and non-local competitors should be included in regulators' analyses of merger and acquisition applications. Suppose Bank A buys Bank B. Merged Bank AB will have a higher market share in a local market defined only by banks than in a market defined by banks and other institutions such as S&Ls. Both the actual competitive effects on consumers and the chances for regulatory approval are affected by whether or not banks are uniquely included in the market.

Peter Eisemann of Georgia State University provides a summary of the evidence that banks are not unique. Generally, Professor Eisemann finds that small businesses have access to lenders other than banks, particularly the trade credit of other business firms. If this evidence is correct, then there is a good case for saying that there is nothing unique any more about banking and that other competitors should be included in the analysis of "banking" markets.

Nor can the uniqueness question be resolved only by looking at local competitors. Since many of these other competitors *are* non-local, Professor Arnold A. Heggestad of the University of Florida and Visiting Scholar at the Federal Reserve Bank of Atlanta discusses the spread of banking-related activity by banks and bank holding companies headquartered in other cities.

Nonlocal competition is not a growing phenomenon in all markets, Heggestad points out. It seems to reflect shifts in relative growth rates in various markets. Banks headquartered in the industrial Northeast, where recent growth has not been rapid, have been interested in establishing a presence in more rapidly growing markets. They have been able to do so because new communications systems and travel have made it feasible to maintain geographically dispersed operations mainly through nonbank subsidiaries such as finance companies and Edge Act corporations. From this we can expect that if present legal barriers to interstate banking are lessened, bank responses should be targeted to higher-growth markets, and may tend to originate from institutions in lower-growth markets.

On the face of it, such a reallocation would seem efficient and appropriate to many economists. But Heggestad goes on to make an interesting distinction between nonlocal competition as a response to "real" economies (in situations where new entrants think they can provide services more cheaply, efficiently and profitably) and "pecuniary" economies which result specifically form regulatory treatment. Can larger banks offer higher interest rates on deposits because they are more efficient, or because regulators permit them to operate with lower capital-asset ratios than their smaller competitors? Similarly, would banking markets be more efficient if the services now offered by non-local corporations and the like were offered through banking enterprises operating in many local markets? Or is the "localness" assumption erroneous, and the concentration of resources and "linked" competition in many markets actually detrimental to overall market efficiency? These are the kinds of questions regulators will have to ponder in the new environment as nonlocal competition becomes more widespread.

In the next article, Professor Duane Graddy of Middle Tennessee State University extends some of the same concerns to local banking markets. How do we define a "banking market" under the new environment, he asks, restating some questions we asked earlier about the circumstances under which thrift institutions should be included. Can we even define a geographic market for a bundle of services, or is it necessary to unbundle the services and develop a series of product markets? Is the "cluster of services" idea still viable in the new environment? Graddy feels it is (in small markets).

Looking particularly at the kinds of smaller banking markets so common in the Southeast where a small number of banks have traditionally split the business, Graddy offers a list of considerations for analyzing the new situation: Has market performance generally been affected by the number and relative size of institutions offering banking services? Have nonbank institutions offered bank-like products prior to the Deregulation Act? Will thrifts in the market continue to diversify into banking services? Does the public perceive them as banks? These are similar to Cox's questions, but put in a different context.

New entry by thrifts will not necessarily produce lower prices and greater efficiency, Graddy points out, if competitors in specific markets continue to exhibit price leadership types of behavior.

If deregulation sets off a consolidation movement that eventually reduces the number of institutions within the financial services industry, the result could be a structure similar to other industries with few competitors where prices are rigid and competition is on a non-price basis.

The first five articles have all dealt, in one way or another, with the efficiency and performance of banking markets. In the sixth, Professor James A. Verbrugge of the University of Georgia focuses instead on regulatory treatment of the institutions currently feeling the greatest pressure in the Southeast: the savings and loan associations. Many associations are currently beset by a

severe earnings squeeze in transition, and this squeeze will only be alleviated by reductions in inflation and short-term interest rates, and in realignment of the portfolios of savings and loans. In this environment, regulators need to be looking for alternatives to merging troubled S&Ls with healthier institutions. Traditionally, thrifts without enough capital to cover periods of earnings losses have been merged — through the auspices of the regulators — with stronger thrifts. Are there, Verbrugge asks, other sources of capital for troubled thrifts as they struggle through the transition period, and what are the implications for using these alternatives?

Turning next to longer-run issues, Verbrugge raises more questions about capital: What is adequate capital for a thrift institution? How should it relate to deposit insurance? Do managers of mutual associations behave differently from managers of stock associations, particularly in view of the evidence that they tend to carry lower-risk portfolios? In the longer run, Verbrugge says, regulators need to devote more study to dealing with interest rate risk and maturity imbalance. What are the implications of hedging in futures markets, for instance, and what should be the role of new-environment thrifts in equity participations (mortgage lending at below market rates in exchange for a share of the equity)? Verbrugge has provided us with an extremely useful list of questions for analyzing savings and loan associations in the future.

Professor Joseph F. Sinkey of the University of Georgia provides an appropriate conclusion by focusing on the regulator's traditional concerns of safety and performance.

On the safety (financial health) side, he raises some particularly intriguing questions. How can the regulator (and the customer) measure the risk facing a financial institution, particularly in this transition period? How should distressed institutions be handled, and are there reasonable alternatives to the traditional response of emergency mergers? Sinkey discusses the importance of capital sources and the need for a fresh regulatory approach to capital adequacy. (Capital adequacy is conventionally measured by a specific set of ratios and indicators.) "For an industry that has been programmed for change in a piecemeal and evolutionary way," says Sinkey, "these changes may come as a cultural shock. It is imperative that regulators, financial leaders and researchers adjust their expectations of what kind of safety and what kind of economic performance they should expect from depository institutions."

In each of these papers, there are more questions than answers. That was intended. We hope that this series of articles and the perspectives and expertise they represent will be useful to those who join with us in peering through the murkiness of the financial future.

Next month, the ***Review*** *will continue its examination of this crucial topic with a summary of a major conference on "The Future of the Financial Services Industry" sponsored by the Federal Reserve Bank of Atlanta on June 3-4, 1981.*

Deregulation, Innovation, and New Competition in Financial Services Markets: An Overview

B. Frank King, Research Officer at the Atlanta Federal Reserve Bank, describes the current process as an integration of financial markets across institutions and space. This integration casts doubt on the conventional regulatory definition of commercial banks — as institutions offering a unique cluster of services in a market limited to local competitors.

Discussions of our changing financial system have become quite common in recent months. Experts and laymen alike are trying to understand such new things as NOW accounts, money market mutual funds, cash management accounts, and explicit pricing of financial services. In recent years deregulation, most clearly demonstrated by the Depository Institutions Deregulation and Monetary Control Act (the "Deregulation Act"), has broadened the services potentially offered by financial institutions. Innovative financial arrangements, such as the money market funds, have further blurred institutional and geographic distinctions and overcome legal and geographic barriers that have long inhibited financial institutions.

Wider powers for financial institutions, relaxation of barriers to geographic expansion, innovative financial arrangements, deregulation of interest on deposits, and more explicit pricing of financial services can all be expected to have impacts on how the financial system operates. These changes seem likely to produce more competition among financial institutions, increasing the number and types of competitors in many markets for financial services. By increasing the number and types of competitors and by providing opportunities for institutions to enter new markets, the changes may also influence the soundness of individual institutions and the stability of the financial system. More broadly, one would expect such changes to affect the cost of producing and delivering financial services, their prices, their availability, and the process of innovation of new financial arrangements.

The Federal Reserve is vitally interested in competition and safety in financial markets and in the performance (overall efficiency) of financial markets and the financial system. In a period of rapid change, however, any regulator's ability to analyze and decide issues of competition, safety and performance declines. There are too many new factors with unknown implications. History offers little guidance. New factors and unknown implications call for research, and research calls both for properly stated questions and for information. In this issue, we attempt to state some researchable questions about the implications of new competition for financial services.

To start, let us review briefly some elements of the new competition and how the Federal

Reserve is involved in it. The process that is going on in our financial system is an integration of financial markets across institutions and space. Some of the integration is coming about because changing laws and regulations are conducive to it. Some of it is coming about because innovators have found new ways of profitably providing financial services.

Deregulation Act

The centerpiece of deregulation so far is the Deregulation Act of 1980. By providing NOW accounts, consumer lending, and peripheral powers for savings and loan associations and mutual savings banks nationwide, and by affirming share draft account powers for credit unions, it tripled the number of institutions potentially offering a "full line" of consumer financial services. All of these institutions will not offer all services, but there is evidence that the number of competitors in some markets is increasing significantly.

The Deregulation Act also schedules the phase-out of interest ceilings on time and savings deposits. While many would agree that the long-run implications of this are positive, few are confident that the transition problems will not be serious. Other significant aspects of the Deregulation Act are its provision for limited business lending by savings and loan associations and mutual savings banks and pricing of Federal Reserve services. Both provisions are likely to increase the competitiveness and efficiency of the financial system.

"While many would agree that the long-run implications . . . are positive, few are confident that the transition problems will not be serious."

The Deregulation Act is the most dramatic of the new innovations. There is, however, a steadily lengthening list of changes that serve to add competitors, broaden geographic spread of institutions' markets, and offer new ways of accomplishing financial arrangements.

Redrawing the Financial Services Map

On the funds gathering, or deposit side, new competitors include institutions that were not found in lists of competitors of depository institutions even five years ago. The dramatic growth of money market funds and the recent strong reaction to them by bank and thrift institution managers demonstrate the money funds' role as competitors for deposits. A brokerage firm advertises a cash management account which ". . . may be the most important financial innovation in years" — another deposit competitor offered nationwide by a nondepository institution. American Express' widespread cash dispensers and more easily available commercial paper are additional competitors in deposit markets that were once virtually the sole province of banks and thrifts.

On the loan side, we find older institutions offering more services and expanding geographically. Loan production offices, representative offices, nonbank operations, and Edge Act corporations of large banking organizations have been rapidly expanding across state lines into areas where the organizations may not accept deposits. Commercial and captive finance companies (finance companies owned by producers, such as auto or farm equipment manufacturers) have reportedly expanded from their traditional equipment financing function to offer receivables and inventory financing in some parts of the country. Citibank's nationwide credit card distribution expands that organization's consumer lending well beyond the state in which it is headquartered.

The Regulators' View

These integrating forces have to be met at several points by financial regulators. In the new environment, some of the banking agencies' assumptions about competition may be outmoded. In their analyses of competitive impacts of these transactions, for example, the agencies have treated commercial banks as offering a unique cluster of services in a market limited to local competitors. Only local banks have been considered competitors. The changes just described cast doubt on all three characteristics assumed for bank competition: uniqueness, clusteredness, localness. Yet the conventional treatment has been accepted by the U.S. Supreme Court in several decisions.

"In the new environment, some of the banking agencies' assumptions about competition may be outmoded."

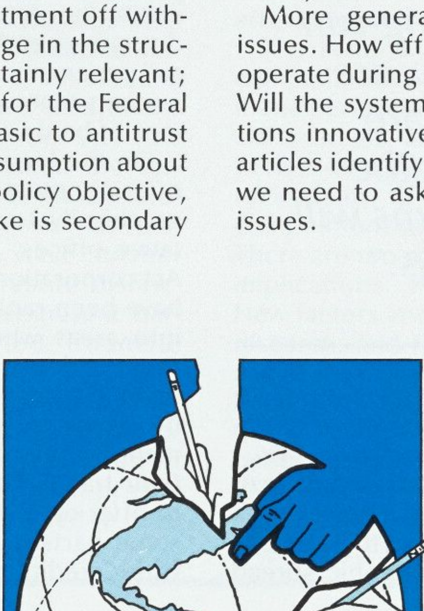
We cannot just write the treatment off without evidence. Evidence of change in the structure of financial markets is certainly relevant; however, that is not sufficient for the Federal Reserve's policy or interests. Basic to antitrust law and its enforcement is an assumption about the efficiency of markets. As a policy objective, market structure for its own sake is secondary to the performance of institutions and markets. That points to a need for evidence about the changing structure's impact on the performance of markets and institutions. It is needed not so much to convince the Supreme Court but to tell us how to analyze bank acquisitions and mergers, how to regard the expanding nonbank activities of bank holding companies, and whether to hasten or deflect the move toward interstate banking.

"Will the financial system be able to handle new conditions innovatively and soundly?"

Recent changes in the financial system have safety implications also. New entrants in activities where larger size leads to greater efficiency are likely to threaten some institutions. Add to these factors competitive pressure to develop new products and the cost of introducing new products; stir in sharply fluctuating interest rates, and you have at least the possibility of problems among financial institutions. Where, when, and how are significant problems likely to emerge? How should they be dealt with in order to ensure both stability and efficient performance at the same time? Evidence is not clear yet.

More generally, there are two important issues. How efficiently will the financial system operate during and after this period of change? Will the system be able to handle new conditions innovatively and soundly? The following articles identify more specifically the questions we need to ask as we deal with these central issues. ER

—B. Frank King



Bank-Thrift Competition in the New Environment: The Southeastern Evidence So Far

William N. Cox, Vice President and Associate Director of Research, Federal Reserve Bank of Atlanta, provides evidence that banks are no longer unique suppliers of financial services to households. Thrifts are entering the local markets, but the early shape of the competition raises several questions for further research.

Savings and loan associations in the Southeast are competing strenuously with banks to provide household financial services, according to the evidence so far in 1981. Virtually all S&Ls have chosen to offer the new NOW accounts. Generally, they are pricing their NOW accounts cheaply in relation to nearby commercial banks. They have already moved into products related to their traditional mortgage and savings business, and are now moving quickly and significantly into the installment and auto loan business. So when one looks at purpose and intentions, our region's thrifts are moving toward full-service banking. There is little evidence that any significant proportion of the thrifts see themselves sticking solely to traditional product lines, or that they are positioning themselves as mortgage bankers.

Southeastern thrifts have decided to compete aggressively with the banks for the new NOW account business. Have their efforts been successful? As we answer this question, we can take the opportunity to pose questions which need further analysis in the context of this bank-thrift competition.

Early Surprises in NOW Race

The initial dollar volume of NOW accounts opened at southeastern financial institutions — banks and thrifts — far exceeded our projections.[1] In each of the six states falling within the Sixth Federal Reserve District, the volume of NOW account balances opened during the first ten weeks of 1981 reached levels we had projected for about the middle of 1982. (The same pattern has been magnified nationally, of course, adding elements of confusion to the interpretation of monetary aggregates so far this year, but that's another story.)

At banks and thrifts in Georgia, for example, we had projected $500 million in NOW account balances by the fourth quarter of this year, and $1240 million by the fourth quarter of 1982. By the end of the tenth week of 1981, banks and savings and loan associations in Georgia had already posted $712 million in NOW account

[1] We prepared these projections on the basis of relationships between NOW balances and income in New England, New York and New Jersey. See William N. Cox, "NOW Accounts: Applying the Northeast's Experience to the Southeast," **Economic Review**, Federal Reserve Bank of Atlanta, September-October 1980.

balances.[2] The other five states show similarly surprising strength.

In Alabama we expected $340 million in the fourth quarter of 1981, but we got $452 million in the first ten weeks of the year.

In Florida we expected $1.0 billion in the fourth quarter of 1981, but we got $2.54 billion after ten weeks.

In southern Louisiana we expected $400 million in the fourth quarter of 1981, but we got $465 million after ten weeks.

In southern Mississippi we expected $200 million in the fourth quarter of 1981, but we got $224 million after ten weeks.

In eastern and central Tennessee we expected $420 million by the fourth quarter of 1981, but we got $479 million after ten weeks. All over the Southeast, NOW balances accumulated much faster than we had expected.

This strong initial volume mainly reflects conversions of high-balance bank checking accounts, as we shall see. It raises some interesting questions. Many commercial bankers closely analyzed their own portfolios of household demand deposits, and made sophisticated calculations about which customers would find it financially advantageous to convert their demand deposit accounts to the new NOW accounts. There have generally been many more dollars converted than the earlier sharp-pencil figuring suggested. Why? Perhaps many customers didn't figure the conversion decision properly. Perhaps high-balance customers are attracted to NOWs for more than sharp-pencil reasons. On the face of it, there is an element of "irrationality" here. This may be a vote for convenience over net interest by banking customers.

"The initial dollar volume of NOW accounts . . . far exceeded our projections."

Market Share: Banks Start Well

One reason we can be fairly sure the bulk of the initial buildup represented straight conversions from bank demand deposits to NOW accounts at the same banks is that the banks were extremely successful in capturing a large share. If we look at Georgia again, as a representative state where we had expected banks would attract an 80 percent share, the first ten weeks of activity showed the banks getting a 92 percent share of NOW balances. In our other five states, as well, the commercial banks substantially exceeded the market shares we expected them to get on the basis of our analysis of the New England experience. The corresponding low S&L shares were despite the fact that S&Ls across the District priced their NOW accounts much more cheaply than the banks. Even in Florida, where S&Ls began with a strong deposit base, advertised heavily and priced aggressively, thrifts posted a 20 percent share during the first ten weeks compared with the 40 percent we had expected. Again, the statistics, the anecdotal conversations we have had with bankers and savings and loan officials, and the corresponding national pattern all suggest the reason for the high initial market shares posted by southeastern banks was their success in converting many of their previous demand deposit customers to NOW accounts at the same institution. Unfortunately, we have no data on number of accounts or average balances yet, so we cannot confirm that these were high-balance accounts.

". . . the banks were extremely successful in capturing a large share."

Between the tenth week and the eighteenth week (from 3/11/81 to 5/6/81), however, the picture has changed and moved much closer to what we expected. The rate of increase of new accounts slowed dramatically in each state. Total NOW account balances in the Sixth Federal Reserve District grew only 17 percent between mid-March (the tenth week) and early May (the eighteenth week). Six dollars of every seven in southeastern NOW accounts by then

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[2] Based on reserve-accounting report supplied to the Federal Reserve Bank of Atlanta for the week of March 11, 1981. Exclusion of smaller institutions understates these estimates by about five percent.

had been put there before mid-May, in other words. The big spurt was over, apparently, and had been replaced by steady upward growth in each of our six states.

Banks' Share Slows

As the growth slowed past the initial spurt, the bank share of NOW balances began to fall. Districtwide, between March 11 and May 6, banks received a 76 percent share, compared to 86 percent in the earlier period. Because of the reduced volume, the overall share only fell to 85 percent, however. In Florida, 29 cents of each newly-added dollar landed in S&Ls; in Alabama, 18 cents; in Georgia, 21 cents; in southern Louisiana, 13 cents; in southern Mississippi, 11 cents; and in eastern and central Tennessee, 16 cents. These proportions were much closer to what we had previously predicted from the New England experience (see Table I). The March-to-May figures are probably more representative of the activity we can expect to see, and probably come closer to suggesting the kind of eventual market share we can expect to see once the market reaches maturity.

Table 1
NOW Balances: Commercial Bank Market Shares[1]
(percent)

	Projected by FRB Atanta[2]	Actual 3/11/81	Actual 5/6/81	Balances Added Between 3/11 and 5/6/81
Alabama	80	92	90	82
Florida	60	80	79	71
Georgia	80	92	90	79
Louisiana	80	94[3]	93[3]	87[3]
Mississippi	85	95[3]	95[3]	89[3]
Tennessee	85	93[3]	92[3]	84[3]
Sixth District		86	85	76

[1](NOW balances at commercial banks) ÷ (NOW balances at banks and savings and loan associations)
[2]**Economic Review**, Federal Reserve Bank of Atlanta, September-October 1980.
[3]Sixth District portion only.

Our earlier projections of market share where based on two assumptions derived from the New England experience: (1) that commercial banks, because of higher minimum balance requirements and for other reasons, would attract average balances in their NOW accounts of two to two-and-a-half times the average balances of NOWs at S&Ls, and (2) that S&Ls would attract accounts in twice the proportion of their share of banking offices (head offices plus branches).[4] The second of these assumptions reflected our feeling that the thrifts would generally compete more aggressively than banks for new accounts, in terms of both account pricing and non-price inducements such as advertising. Lacking number-of-accounts data, we cannot confirm the validity of these two assumptions individually, but we can say that the evidence of the March-May period is consistent with our expectations of more aggressive marketing by the savings and loans.[4] So in terms of results as well as in terms of intentions and pricing, it certainly appears that savings and loans are competing aggressively for NOW account business, rather than offering the new accounts passively and sticking to their traditional business.

". . . many thrifts are energetically promoting the conversion of their own savings balances into the new accounts."

Not all of the new NOW balances at savings and loan associations are being moved from commercial bank demand deposit accounts, of course; many thrifts are energetically promoting the conversion of their own savings balances into the new accounts. How much is difficult to tell, particularly in a period when savings and loans have generally been reporting substantial outflows of time and savings account balances into money market mutual funds, which nationally were increasing by $43.6 billion during the same December-to-May period which gave us a $38.4 billion increase in NOW-type accounts. On the basis of both common sense and the results of marketing studies, however, the evidence is consistent with the

[3]Ibid, September-October, **Economic Review**.
[4]See "NOW Survey: Perspectives and Objectives," **Economic Review** February 1981, and "NOW Competition: S&Ls Start Fast, Banks More Conservative," **Economic Review**, April 1981.

notion that customers find changing financial institutions a more substantial decision than changing accounts within the same institution, and accordingly that the first wave of conversions is not so representative of the future of bank-thrift competition for NOW accounts as the later experience with the higher thrift market share.

Consumers' View

Do customers perceive bank NOWs and thrift NOWs as the same product? The strong bimodal pattern of NOW pricing in the Sixth District, and nationally for that matter, provides us an opportunity to test that proposition. The dichotomy in pricing is really quite striking. Based on our January sampling of NOW account pricing at 127 commercial banks and 60 savings and loan associations within the boundaries of the Sixth Federal Reserve District, we found that 77 percent of the thrifts were offering charge-free checking with a mimimum balance requirement of $500 or less, compared with only 4 percent of the banks we sampled. About 91 percent of the banks reported offering charge-free checking only with minimum balances of $1000 or more, whereas only 20 percent of the thrifts required minimum balances that high. For reasons we have analyzed elsewhere, the pricing distinction is clearcut.[5] In addition to gathering this information about initial pricing from the samples just described, we have also recorded the initial pricing of all banks and thrifts in six specific southeastern markets. These markets were selected for their diversity in characteristics such as concentration, initial bank-thrift market share, strength of recent economic growth, stability of recent economic growth, and the size of population. So both on a District sample basis and in specific markets, we can return at intervals and see if we can find any convergence between the minimum balance requirements of banks and thrifts. The New England experience generally suggests a lack of convergence, but the experience there developed differently and may be misleading. If the convergence persists, then there is the implication that customers indeed tend to view the accounts at different types of institutions as different products.

Credit Unions

In the figures we have cited up to this point, we have made no mention of share drafts at credit unions in the Southeast. Functionally, they are very similar to NOW accounts, although that does not necessarily mean customers view them as substitutes. Our recent survey suggests that about two-thirds of the Southeast's larger credit unions (those with $5 million or more in assets) offer share drafts. At about half of offering institutions, the accounts are charge-free regardless of minimum balances. By the end of May, larger credit unions

[5] "NOW Pricing: Perspectives and Objectives," **Economic Review**, February 1981.

within the boundaries of the Sixth Federal Reserve District had posted $242 million of share draft balances, compared with $873 million of NOW balances at savings and loan associations and $4850 million of commercial bank NOWs. Share drafts, in other words, amounted to about four percent of the District's NOW balances.

But all of the NOW balances have been accumulated since December 31, 1980, when NOW accounts became legal in the Southeast, whereas only $50 millon of the share draft balances have been added since year end. (Share draft accounts have been permissible at certain federally-chartered credit unions for several years.) So less that one percent of the transactions account balances posted since the beginning of 1981 have been at credit unions. Accordingly, we feel justified in excluding credit union share drafts from our market share analysis. As share drafts expand, they could become large enough to be reckoned with, however. As it stands, the credit union data, given the prevalance of no-minimum-balance accounts, lends some weight to the hypothesis that customers may not view various kinds of transactions accounts as substitutes, even though they are functionally quite similar and priced attractively.

". . . there is the implication that customers tend to view (NOW) accounts at different types of institutions as different products."

S&Ls Launch New Services

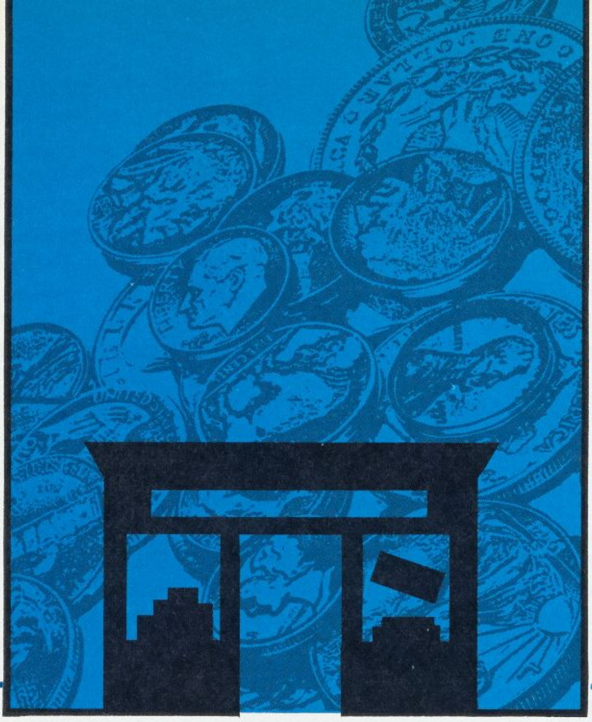
We have accumulated one additional set of evidence in recent months, to which I alluded earlier. Back in February, we asked each savings and loan association in our 60-institution sample about 10 household financial services — whether the association offered them and whether they planned to offer them in the near future if they didn't already. The responses, as we have described elsewhere, confirm the image of savings and loans as incipient providers of household financial services.[6] Three out of five associations were either offering auto loans and other consumer installment loans, or were planning to offer them soon. There is an obvious incentive, in today's environment, for thrifts to shorten the maturity of their asset portfolios. But the strength of this response — within two months of being permitted to offer a new line of service — suggests strong interest in entering the household financial service centers, particularly when coupled with the universality and aggressive pricing of NOW accounts. Also, we found that almost 7 out of 10 thrifts we sampled were offering some form of "overdraft protection," or planned to offer it soon.

So the evidence in the Southeast, so far, boils down to three propositions: (1) banks and savings and loans are both offering services for which there is high consumer interest, particularly in the case of NOW accounts; (2) savings and loan associations, by their pricing and offering decisions, give evidence that they see themselves as household financial institutions, and (3) the households themselves may not yet regard similar financial-service products at the two types of institutions as close substitutes. ER

". . . customers find changing financial institutions a more substantial decision than changing accounts within the same institution . . ."

[6] "Survey of S&L Services," **Economic Review**, June 1981.

—William N. Cox



The Financing of Small Business

Peter Eisemann, Associate Professor, Department of Finance, and Victor L. Andrews, Chairman and Mills B. Lane Professor of Banking and Finance, Department of Finance, Georgia State University, find that banks make up only a relatively small part of the funding sources for small business. Small business loans, therefore, cannot be considered a service unique to banks.

One very important user of financial services and products is a group of firms known collectively as small business. Together, these firms represent more than 95 percent of all business organizations and control slightly more than one-half of all business receipts.[1] While these firms demand many different services and products, the product of particular interest in this paper is debt financing. More specifically, what are the alternative sources of debt financing available to small business and how do commercial bank loans fit into this menu of financing options?

Despite the absence of any centralized data source detailing the financial structure of small business, a fairly good picture of overall financing patterns can be acquired by piecing together information from several individual sources. For example, Table 1 provides a gross breakdown of financing for a sample of small and large non-financial corporations. Small firms derive about two thirds of their funds from debt sources, and over one-half of debt funds are short term in nature. Only 15 percent of all funds sources are in the form of mortgages, notes and bonds.

"Bank lending accounts for only 16.5 percent of all funds sources and 30 percent of all debt."

Table 2 presents more detailed data on small manufacturing firms. Debt constitutes 55 percent of all funds, and two-thirds of the debt is

[1] Much of this paper is drawn from a larger study sponsored by the Small Business Administration entitled, "Adequacy of Financing for Small Business." There are numerous definitions of small business used in the literature. While the numbers just cited relate to the SBA classification system, other statistics in this paper are derived using the small business classification system of the data preparing organization. However, in all cases only nonfarm businesses are included.

Table 1
Liabilities and Equity of Non-Financial Corporations*
(Percentages of Liabilities and Net Worth)

	1975	
	Small**	All
Accounts and Notes Payable	30.5	20.1
Other Current Liabilities	7.6	8.0
Mortgages, Notes, and Bonds	15.8	22.6
Other Liabilities	11.1	7.1
Net Worth	35.0	45.2
Debt/Equity Ratio	1.86	1.37

*All active corporations less agriculture, forestry and fishing, finance, insurance and real estate.
**Small firms are those with less than $500,000 in assets.
Source: U.S. Internal Revenue Service, **Statistics of Income**, Corporation Income Tax Returns.

short-term. The interesting thing about Table 2, however, is that it puts bank lending to small manufacturing firms into proper perspective. Bank lending accounts for only 16.5 percent of all funds sources and 30 percent of all debt. Clearly, while bank lending is important to these firms, other sources are even more important. For example, ignoring debt other than loans, 11 percent of all funds are provided by non-bank lenders. In addition, trade credit supplies over 17 percent.

Table 2
Liabilities and Equity of Manufacturing Firms
(Percentages of Liabilities and Net Worth)

	1978	
	Small*	All
Short-term loans		
a. Loans from banks	6.7%	2.0%
b. Commercial paper	.1	.5
c. Other	1.5	.6
Trade accounts and notes payable	17.2	9.5
Income tax accruals	1.8	2.5
Current portion of long-term debt		
a. Loans from banks	1.7	.4
b. Other	1.1	.7
Other current liabilities	7.1	9.2
Total current liabilities	37.2	25.5
Long-term debt		
a. Loans from banks	8.1	3.7
b. Other	8.4	13.1
Other liabilities	1.4	6.1
Total liabilities	55.2	48.3
Equity	44.8	51.7
Debt/Equity Ratio	1.23	.93

*Small firms had assets of less than $5,000,000.
Source: U.S. Federal Trade Commission, **Quarterly Report for Manufacturing, Mining and Trade Corporations**, Table G-2.

Table 3
Liabilities of Nonfinancial, Nonfarm, Noncorporate Business, Except Housing
(Percentage of Total Liabilities)

	1979
Credit Market Instruments	78.2%
Commercial Mortgages	24.3
Bank Loans, not elsewhere classified	9.6
Other Direct Loans	37.3
U.S. Government	26.6
Finance Companies	10.7
Bankers Acceptances	7.0
Trade Credit	21.8

Source: U.S. Board of Governors of the Federal Reserve System, **Flow of Funds Accounts, Assets and Liabilities Outstanding, 1969-1979**, February 1980, pp. 542, 891.

Evidence on liabilities for unincorporated business is shown in Table 3. Because it is very difficult to separate business finance from personal finance when dealing with unincorporated business, the data in Table 3 must be used carefully. On the other hand, since so many small businesses are unincorporated, Table 3 provides a valuable glimpse at a large part of the small business universe.

The importance of trade credit to small business is underscored in Table 3. In addition, commercial mortgages, governmental loans, and finance company loans are large sources of funds. While bank loans appear to be a small source (9.6 percent), the participation of banks in the mortgage and acceptance markets means that the actual role of banks is considerably larger.

As the data on trade credit indicate, interbusiness financing is very important to small business. Large firms recognize that small business reliance on trade credit makes the extension of trade credit an important selling tool. As a result, generous terms are sometimes offered. Furthermore, during tight money periods small businesses may stretch out their payments to suppliers. The result is a sort of intermediation where small firms borrow from large firms through trade credit, and large firms in turn finance themselves in the credit markets.

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The *Economic Review* Statistical Supplement

Last month we inaugurated a new Review feature: a four page Statistical Supplement. Its purpose is to provide the most comprehensive round-up of current economic data available for the six states within the Sixth Federal Reserve District (Georgia, Florida, Mississippi, Tennessee, Alabama, and Louisiana). The publication of this large volume of data on a monthly basis is made possible by two new developments: the requirement for all depository institutions to report deposit data weekly to the Federal Reserve (beginning late last year), and the completion of an extensive new database here at the Atlanta Federal Reserve Bank. For most series, current data are reported compared to the previous reporting period and the same period in the prior year. At a quick glance, the reader can compare activity in his state to that in another state, the Southeast region or the nation, using the reported growth rates. The states are located in the same position on each page so they can be easily followed throughout the supplement. The reader is encouraged to keep the supplement as a handy guide to current economic activity and as an historical reference of economic change. The supplement is divided into four sections:

Finance

The financial data are collected weekly by the Federal Reserve Banks. Reporting requirements of all depository institutions began in late 1980. Therefore, year-ago data are not available for annual growth calculations. Each month, the growth of deposits from a December 31, 1980, base will be annualized to indicate the pace of change. One of the key elements of this table is the data on NOW and share draft accounts. Since the instruments were legalized only recently, it is important for institutions to judge how their own experience compares to the state, regional, and national aggregates. Loan data are not collected on a comprehensive and frequent basis by the Federal Reserve Bank, but the Federal Home Loan Banks report mortgage loan data from which we have extracted commitments and outstanding balances.

Employment

The civilian labor force employment data are reported from the Bureau of Labor Statistics survey of households. Comparison over time and between states is best done with the annual percent change figure. The unemployment rate is reported seasonally adjusted, since it is such a commonly used national figure. Insured unemployment is the number of persons out of work who are covered by the government's unemployment insurance program and are currently receiving benefits. The insured unemployment rate is the number of persons who are currently receiving benefits as a percentage of all those covered by unemployment insurance. The average weekly hours worked in manufacturing industries is a leading indicator, since many firms reduce work loads before they begin laying off individuals during an economic contraction. The opposite trend occurs during the early stages of an expansion. Earnings figures in manufacturing industries are best compared over time within one area. Comparison between areas is faulty in wage rate analysis since the mix of industry may differ.

Construction

Construction contracts and permits are reported as a 12-month cumulative rate. The May data represent the sum of construction activity in the period from June, 1980, through May, 1981. This method eliminates seasonality problems and gives a current estimate of the annual level of construction. The 12-month cumulative rate simulates the method of reporting housing starts, Gross National Product, and personal income which are always referred to on an annual basis. The permit data and the contracts data are from two different reporting sources and do not encompass exactly the same activity. The prime purpose of reporting the permit data is to give an indication of the mix of multi- and single-family construction taking place.

General

Personal income is reported quarterly; therefore, the figures will not change with every issue. Taxable sales data are used as a proxy for retail sales and are compared to that series nationally. The 12-month cumulative rate is used to eliminate seasonal fluctuations. Plane passenger arrivals at major airports are an indication of tourist and business activity. Petroleum production is significant only for Louisiana. Since that state's income and employment are largely housed in the petroleum industry, changes in production would have a major impact on the state's economy. The Consumer Price Index is available for only two cities in the six southeastern states — Atlanta and Miami. The indexes, reported bimonthly on alternating months, are relevant for these cities only and do not reflect price changes in the entire Southeast. Agriculture prices are significant for farmers, who represent a large income-producing segment of this region. Also, the price changes of individual commodities are indicative of future change in the food component of the Producer and Consumer Price Indexes.

FINANCE

$ millions	JUN 1981	MAY 1981	DEC 1980	ANN. RATE OF CHG.
UNITED STATES				
Commercial Bank Deposits	1,023,293	1,010,415	1,017,065	+ 1
Demand	296,189	301,203	331,555	-25
NOW	41,683	41,384	0	
Savings	155,870	158,657	166,347	-15
Time	399,529	542,010	525,805	-57
Credit Union Deposits	37,123	36,733	34,472	+18
Share Drafts	2,104	2,107	1,631	+69
Savings & Time	33,010	32,613	30,692	+18
SOUTHEAST				
Commercial Bank Deposits	110,174	109,961	104,499	+13
Demand	34,490	35,610	37,660	-20
NOW	5,383	5,306	0	
Savings	15,362	15,688	16,343	-14
Time	58,254	56,899	51,519	+31
Credit Union Deposits	3,386	3,341	3,209	+13
Share Drafts	242	241	195	+57
Savings & Time	2,895	2,870	2,797	+ 8
ALABAMA				
Commercial Bank Deposits	12,651	12,678	12,262	+ 8
Demand	3,374	3,599	3,954	-35
NOW	476	477	0	
Savings	1,637	1,662	1,745	-15
Time	7,503	7,346	6,754	+26
Credit Union Deposits	553	544	521	+15
Share Drafts	51	51	41	+58
Savings & Time	495	491	479	+ 8
FLORIDA				
Commercial Bank Deposits	36,662	36,820	35,061	+11
Demand	12,762	13,214	14,216	-24
NOW	2,335	2,361	0	
Savings	6,569	6,779	7,092	-18
Time	15,921	15,527	13,996	+33
Credit Union Deposits	1,573	1,550	1,491	+13
Share Drafts	137	135	106	+70
Savings & Time	1,200	1,192	1,177	+ 5
GEORGIA				
Commercial Bank Deposits	14,750	14,576	14,179	+10
Demand	5,944	6,035	6,652	-25
NOW	758	751	0	
Savings	1,616	1,624	1,645	- 4
Time	7,412	7,175	6,832	+20
Credit Union Deposits	572	565	543	+13
Share Drafts	18	18	12	+19
Savings & Time	541	536	517	+11
LOUISIANA				
Commercial Bank Deposits	19,669	19,449	18,696	+12
Demand	6,002	6,086	5,509	+21
NOW	791	698	0	
Savings	2,483	2,506	2,538	- 5
Time	11,066	10,756	10,089	+23
Credit Union Deposits	86	83	57	+21
Share Drafts	5	5	4	+60
Savings & Time	80	78	52	+28
MISSISSIPPI				
Commercial Bank Deposits	9,124	9,168	8,662	+13
Demand	2,296	2,453	2,620	-29
NOW	396	398	0	
Savings	790	811	861	-20
Time	5,867	5,765	5,364	+22
Credit Union Deposits	N.A.	N.A.	N.A.	
Share Drafts	N.A.	N.A.	N.A.	
Savings & Time	N.A.	N.A.	N.A.	
TENNESSEE				
Commercial Bank Deposits	17,318	17,270	15,639	+26
Demand	4,112	4,223	4,709	-30
NOW	627	621	0	
Savings	2,267	2,306	2,462	-19
Time	10,485	10,330	8,484	+56
Credit Union Deposits	602	599	597	+ 2
Share Drafts	31	32	29	+16
Savings & Time	579	573	572	+ 3

	JUN 1981	MAY 1981	DEC 1980	ANN. RATE OF CHG.
UNITED STATES				
Savings & Loans				
Total Deposits	510,064	509,119	501,551	+ 4
NOW	5,722	5,656	0	
Savings	98,080	100,848	104,686	-15
Time	405,966	402,409	394,296	+ 7
	APR	MAR	DEC	
Mortgages Outstanding	500,768	498,456	494,179	+ 4
Mortgage Commitments	18,471	17,281	16,021	+46
SOUTHEAST				
Savings & Loans				
Total Deposits	74,739	74,434	72,348	+ 8
NOW	892	889	0	
Savings	12,448	12,913	13,148	-13
Time	61,223	60,427	58,669	+10
	APR	MAR	DEC	
Mortgages Outstanding	72,832	72,367	71,065	+ 7
Mortgage Commitments	3,947	3,786	3,656	+24
ALABAMA				
Savings & Loans				
Total Deposits	4,390	4,382	4,262	+ 7
NOW	48	47	0	
Savings	637	653	691	-19
Time	3,716	3,697	3,572	+10
	APR	MAR	DEC	
Mortgages Outstanding	3,985	3,976	3,947	+ 3
Mortgage Commitments	126	136	140	-30
FLORIDA				
Savings & Loans				
Total Deposits	45,442	45,352	43,964	+ 8
NOW	632	640	0	
Savings	8,326	8,711	8,766	-12
Time	36,271	35,767	34,672	+11
	APR	MAR	DEC	
Mortgages Outstanding	44,163	43,798	42,742	+10
Mortgage Commitments	3,270	3,104	2,984	+29
GEORGIA				
Savings & Loans				
Total Deposits	9,533	9,505	9,259	+ 7
NOW	90	86	0	
Savings	1,337	1,368	1,435	-16
Time	8,129	8,063	7,817	+10
	APR	MAR	DEC	
Mortgages Outstanding	9,441	9,402	9,332	+ 4
Mortgage Commitments	182	190	183	- 2
LOUISIANA				
Savings & Loans				
Total Deposits	7,083	7,028	6,851	+ 8
NOW	50	47	0	
Savings	1,214	1,239	1,253	- 7
Time	5,828	5,749	5,599	+10
	APR	MAR	DEC	
Mortgages Outstanding	6,909	6,877	6,777	+ 6
Mortgage Commitments	221	213	221	0
MISSISSIPPI				
Savings & Loans				
Total Deposits	1,830	1,819	1,794	+ 5
NOW	17	16	0	
Savings	191	195	210	-22
Time	1,628	1,615	1,587	+ 6
	APR	MAR	DEC	
Mortgages Outstanding	2,192	2,189	2,182	+ 1
Mortgage Commitments	54	56	58	-21
TENNESSEE				
Savings & Loans				
Total Deposits	6,461	6,348	6,218	+ 9
NOW	55	53	0	
Savings	743	747	793	-15
Time	5,651	5,536	5,422	+10
	APR	MAR	DEC	
Mortgages Outstanding	6,142	6,125	6,085	+ 3
Mortgage Commitments	94	87	70	+ 3

Notes: All deposit data are extracted from the Federal Reserve Report of Transaction Accounts, other Deposits and Vault Cash (FR2900), and are reported for the average of the week ending the 1st Wednesday of the month. This data, reported by institutions with over $15 million in deposits as of December 31, 1979, represents 95% of deposits in the six state area. The annual rate of change is based on most recent data over December 31, 1980 base, annualized. Savings and loan mortgage data are from the Federal Home Loan Bank Board Selected Balance Sheet Data. The Southeast data represent the total of the six states. Subcategories were chosen on a selective basis and do not add to total.
N.A. = fewer than four institutions reporting.

EMPLOYMENT

	MAY 1981	APR 1981	MAY 1980	ANN. % CHG.		MAY 1981	APR 1981	MAY 1980	ANN. % CHG.
UNITED STATES									
Civilian Labor Force - thous.	106,350	105,680	104,030	+ 2	Nonfarm Employment- thous.	91,860	91,360	90,850	+ 1
Total Employed - thous.	98,803	98,282	96,709	+ 2	Manufacturing	20,380	20,330	20,250	+ 1
Total Unemployed - thous.	7,550	7,400	7,820	- 3	Construction	4,350	4,290	4,470	- 3
Unemployment Rate - % SA	7.6	7.3	7.6		Trade	20,900	20,710	20,500	+ 2
Insured Unemployment - thous.	2,703	2,980	3,347	-19	Government	16,350	16,390	16,560	- 1
Insured Unempl. Rate - %	3.1	3.4	3.9		Services	18,460	18,290	17,750	+ 4
Mfg. Avg. Wkly. Hours	40.1	39.7	39.3	+ 2	Fin., Ins., & Real Est.	5,310	5,280	5,140	+ 3
Mfg. Avg. Wkly. Earn. - $	318	312	280	+14	Trans. Com. & Pub. Util.	5,160	5,130	5,170	- 0
SOUTHEAST									
Civilian Labor Force - thous.	13,021	12,850	12,765	+ 2	Nonfarm Employment- thous.	11,435	11,435	11,170	+ 2
Total Employed - thous.	12,109	12,006	11,934	+ 1	Manufacturing	2,297	2,288	2,262	+ 2
Total Unemployed - thous.	911	843	831	+10	Construction	713	712	691	+ 3
Unemployment Rate - % SA	7.5	7.1	6.9		Trade	2,625	2,630	2,625	0
Insured Unemployment - thous.	252	265	302	-17	Government	2,205	2,221	2,191	+ 1
Insured Unempl. Rate - %	2.4	2.5	2.9		Services	2,142	2,133	2,003	+ 7
Mfg. Avg. Wkly. Hours	40.5	39.7	39.5	+ 3	Fin., Ins., & Real Est.	626	625	594	+ 5
Mfg. Avg. Wkly. Earn. - $	271	265	240	+13	Trans. Com. & Pub. Util.	688	687	670	+ 3
ALABAMA									
Civilian Labor Force - thous.	1,646	1,643	1,660	- 1	Nonfarm Employment- thous.	1,345	1,344	1,360	- 1
Total Employed - thous.	1,502	1,504	1,518	- 1	Manufacturing	357	356	362	- 1
Total Unemployed - thous.	143	139	142	+ 1	Construction	71	71	68	+ 4
Unemployment Rate - % SA	9.3	9.1	8.9		Trade	271	270	277	- 2
Insured Unemployment - thous.	44	47	54	-19	Government	301	302	305	- 1
Insured Unempl. Rate - %	3.5	3.7	4.2		Services	208	208	201	+ 3
Mfg. Avg. Wkly. Hours	40.4	40.0	39.7	+ 2	Fin., Ins., & Real Est.	59	59	58	+ 2
Mfg. Avg. Wkly. Earn. - $	283	280	254	+11	Trans. Com. & Pub. Util.	72	71	72	0
FLORIDA									
Civilian Labor Force - thous.	4,133	4,018	3,923	+ 5	Nonfarm Employment- thous.	3,737	3,750	3,536	+ 6
Total Employed - thous.	3,857	3,800	3,717	+ 4	Manufacturing	470	470	441	+ 7
Total Unemployed - thous.	276	218	206	+34	Construction	281	280	266	+ 6
Unemployment Rate - % SA	7.3	6.2	6.0		Trade	973	980	943	+ 3
Insured Unemployment - thous.	49	53	54	- 9	Government	631	639	636	- 1
Insured Unempl. Rate - %	1.4	1.5	1.6		Services	876	876	782	+12
Mfg. Avg. Wkly. Hours	39.9	39.5	39.9	0	Fin., Ins., & Real Est.	268	268	241	+11
Mfg. Avg. Wkly. Earn. - $	259	254	233	+11	Trans. Com. & Pub. Util.	225	227	217	+ 4
GEORGIA									
Civilian Labor Force - thous.	2,423	2,409	2,394	+ 1	Nonfarm Employment- thous.	2,168	2,166	2,134	+ 2
Total Employed - thous.	2,292	2,277	2,235	+ 3	Manufacturing	520	517	516	+ 1
Total Unemployed - thous.	131	132	159	-18	Construction	99	100	98	+ 1
Unemployment Rate - % SA	5.7	6.0	6.9		Trade	486	487	500	- 3
Insured Unemployment - thous.	42	45	52	-19	Government	444	445	426	+ 4
Insured Unempl. Rate - %	2.1	2.2	2.6		Services	356	356	341	+ 4
Mfg. Avg. Wkly. Hours	40.6	39.8	39.5	+ 3	Fin., Ins., & Real Est.	114	114	109	+ 5
Mfg. Avg. Wkly. Earn. - $	257	250	222	+ 6	Trans. Com. & Pub. Util.	141	140	138	+ 2
LOUISIANA									
Civilian Labor Force - thous.	1,772	1,774	1,708	+ 4	Nonfarm Employment- thous.	1,624	1,621	1,521	+ 7
Total Employed - thous.	1,642	1,645	1,596	+ 3	Manufacturing	215	215	208	+ 3
Total Unemployed - thous.	130	130	111	+17	Construction	152	151	129	+18
Unemployment Rate - % SA	7.5	7.5	6.7		Trade	363	361	360	+ 1
Insured Unemployment - thous.	38	40	47	-19	Government	318	319	300	+ 6
Insured Unempl. Rate - %	2.5	2.7	3.3		Services	280	280	256	+ 9
Mfg. Avg. Wkly. Hours	41.1	40.4	40.8	+ 1	Fin., Ins., & Real Est.	76	76	75	+ 1
Mfg. Avg. Wkly. Earn. - $	346	341	317	+ 9	Trans. Com. & Pub. Util.	127	127	115	+10
MISSISSIPPI									
Civilian Labor Force - thous.	1,024	1,017	1,042	- 2	Nonfarm Employment- thous.	829	831	830	- 0
Total Employed - thous.	946	940	966	- 2	Manufacturing	221	219	219	+ 1
Total Unemployed - thous.	78	77	76	+ 3	Construction	41	41	44	- 7
Unemployment Rate - % SA	8.1	8.2	7.5		Trade	166	166	162	+ 2
Insured Unemployment - thous.	26	27	30	-13	Government	193	196	199	- 3
Insured Unempl. Rate - %	3.4	3.5	3.9		Services	123	124	121	+ 2
Mfg. Avg. Wkly. Hours	39.8	39.4	38.4	+ 4	Fin., Ins., & Real Est.	33	33	33	0
Mfg. Avg. Wkly. Earn. - $	238	235	205	+16	Trans. Com. & Pub. Util.	41	41	42	- 2
TENNESSEE									
Civilian Labor Force - thous.	2,024	1,989	2,039	- 1	Nonfarm Employment- thous.	1,732	1,722	1,788	- 3
Total Employed - thous.	1,871	1,841	1,902	- 2	Manufacturing	513	511	515	- 0
Total Unemployed - thous.	153	148	137	+12	Construction	69	69	86	-20
Unemployment Rate - % SA	7.9	7.8	7.1		Trade	365	366	384	- 5
Insured Unemployment - thous.	53	53	66	-20	Government	318	320	326	- 2
Insured Unempl. Rate - %	3.2	3.2	3.9		Services	298	289	302	- 1
Mfg. Avg. Wkly. Hours	40.5	39.9	39.1	+ 4	Fin., Ins., & Real Est.	76	76	78	- 3
Mfg. Avg. Wkly. Earn. - $	269	260	236	+14	Trans. Com. & Pub. Util.	82	81	87	- 6

Notes: All labor force data are from Bureau of Labor Statistics reports supplied by state agencies.
Only the unemployment rate data are seasonally adjusted.
The Southeast data represent the total of the six states.
The annual percent change calculation is based on the most recent data over prior year.

CONSTRUCTION

12-Month Cumulative Rate	MAY 1981	APR 1981	MAY 1980	ANN. % CHG.
UNITED STATES				
Total Construction Contracts				
Value - $ mil.	154,835	153,090	149,234	+ 4
Nonresidential Contracts				
Value - $ mil.	55,955	55,237	50,058	+ 12
Sq. Ft. - mil.	1,213.2	1,199.6	1,291.7	- 6
Nonbuilding Contracts				
Value - $ mil.	30,451	30,859	34,343	- 11
SOUTHEAST				
Total Construction Contracts				
Value - $ mil.	28,129	27,554	24,166	+ 16
Nonresidential Contracts				
Value - $ mil.	8,226	7,985	7,037	+ 17
Sq. Ft. - mil.	194.8	190.2	189.3	+ 3
Nonbuilding Contracts				
Value - $ mil.	5,819	5,763	4,953	+ 17
ALABAMA				
Total Construction Contracts				
Value - $ mil.	1,978	1,958	1,764	+ 12
Nonresidential Contracts				
Value - $ mil.	537	523	555	- 3
Sq. Ft. - mil.	13.2	12.9	15.9	- 17
Nonbuilding Contracts				
Value - $ mil.	443	449	399	+ 11
FLORIDA				
Total Construction Contracts				
Value - $ mil.	13,841	13,504	11,449	+ 21
Nonresidential Contracts				
Value - $ mil.	3,435	3,234	2,712	+ 27
Sq. Ft. - mil.	89.2	85.3	81.8	+ 9
Nonbuilding Contracts				
Value - $ mil.	2,506	2,506	1,817	+ 38
GEORGIA				
Total Construction Contracts				
Value - $ mil.	3,951	3,904	3,743	+ 6
Nonresidential Contracts				
Value - $ mil.	1,214	1,224	1,239	- 2
Sq. Ft. - mil.	34.6	34.4	37.1	- 7
Nonbuilding Contracts				
Value - $ mil.	755	751	842	- 10
LOUISIANA				
Total Construction Contracts				
Value - $ mil.	3,568	3,487	3,305	+ 8
Nonresidential Contracts				
Value - $ mil.	1,250	1,234	1,387	- 10
Sq. Ft. - mil.	22.0	21.8	21.1	+ 4
Nonbuilding Contracts				
Value - $ mil.	999	997	837	+ 19
MISSISSIPPI				
Total Construction Contracts				
Value - $ mil.	1,820	1,717	1,229	+ 48
Nonresidential Contracts				
Value - $ mil.	631	618	280	+125
Sq. Ft. - mil.	8.7	8.5	8.0	+ 9
Nonbuilding Contracts				
Value - $ mil.	538	452	407	+ 32
TENNESSEE				
Total Construction Contracts				
Value - $ mil.	2,971	2,984	2,676	+ 11
Nonresidential Contracts				
Value - $ mil.	1,158	1,153	863	+ 34
Sq. Ft. - mil.	27.0	27.2	25.4	+ 6
Nonbuilding Contracts				
Value - $ mil.	578	608	652	- 11

	MAY 1981	APR 1981	MAY 1980	ANN. % CHG.
UNITED STATES				
Residential Contracts				
Value - $ mil.	68,429	66,993	64,833	+ 6
Number of Units - Thous.	1,378.5	1,359.1	1,463.1	- 6
Residential Permits - Thous.				
Number single-family	737.8	726.3	787.8	- 6
Number multi-family	501.1	488.8	506.7	- 1
SOUTHEAST				
Residential Contracts				
Value - $ mil.	14,084	13,805	12,177	+ 16
Number of Units - Thous.	323.8	318.3	310.6	+ 4
Residential Permits - Thous.				
Number single-family	160.7	159.1	154.6	+ 4
Number multi-family	132.4	130.4	101.1	+ 31
ALABAMA				
Residential Contracts				
Value - $ mil.	998	986	810	+ 23
Number of Units - Thous.	27.3	27.3	24.0	+ 14
Residential Permits - Thous.				
Number single-family	8.9	9.1	8.6	+ 3
Number multi-family	8.1	8.2	6.1	+ 33
FLORIDA				
Residential Contracts				
Value - $ mil.	7,899	7,764	6,921	+ 14
Number of Units - Thous.	180.2	176.2	174.7	+ 3
Residential Permits - Thous.				
Number single-family	93.8	91.7	89.0	+ 5
Number multi-family	92.1	91.1	71.1	+ 29
GEORGIA				
Residential Contracts				
Value - $ mil.	1,982	1,929	1,662	+ 19
Number of Units - Thous.	46.7	46.0	42.3	+ 10
Residential Permits - Thous.				
Number single-family	28.4	28.4	26.8	+ 6
Number multi-family	11.0	9.9	6.6	+ 67
LOUISIANA				
Residential Contracts				
Value - $ mil.	1,318	1,256	1,081	+ 22
Number of Units - Thous.	26.6	25.7	26.1	+ 2
Residential Permits - Thous.				
Number single-family	12.3	12.1	12.2	+ 1
Number multi-family	9.2	8.8	6.7	+ 37
MISSISSIPPI				
Residential Contracts				
Value - $ mil.	651	647	543	+ 20
Number of Units - Thous.	15.8	15.7	14.3	+ 10
Residential Permits - Thous.				
Number single-family	5.1	5.3	4.6	+ 11
Number multi-family	4.9	5.2	3.1	+ 58
TENNESSEE				
Residential Contracts				
Value - $ mil.	1,235	1,223	1,161	+ 6
Number of Units - Thous.	27.1	27.4	29.2	- 7
Residential Permits - Thous.				
Number single-family	12.2	12.5	13.4	- 9
Number multi-family	7.1	7.2	7.5	- 5

Notes: Contracts are calculated from the F. W. Dodge Construction Potentials. Permits are calculated from the Bureau of the Census, Housing Units Authorized By Building Permits and Public Contracts. The Southeast data represent the total of the six states. The annual percent change calculation is based on the most recent month over prior year.

GENERAL

	MAY 1981	APR 1981	MAY 1980	ANN. % CHG.
UNITED STATES				
Personal Income-$ bil. SAAR				
(Dates: 4Q, 3Q, 4Q)	2,228.3	2,155.8	2,010.0	+11
Retail Sales - $ bil.- SA	85.9	85.8	76.0	+13
Plane Passenger Arrivals (thous.)	N.A.	N.A.	N.A.	
Petroleum Prod. (thous. bls.)	8,564	8,597	8,749	- 2
Consumer Price Index				
1967=100	269	267	245	+10
SOUTHEAST				
Personal Income-$ bil. SAAR				
(Dates: 4Q, 3Q, 4Q)	258.6	249.2	229.5	+13
Taxable Sales - $ bil.	N.A.	N.A.	N.A.	
Plane Passenger Arrivals (thous.)	5575.1	5113.6	6110.6	- 9
Petroleum Prod. (thous. bls.)	1,442	1,443	1,552	- 7
Consumer Price Index				
1967=100	N.A.	N.A.	N.A.	
ALABAMA				
Personal Income-$ bil. SAAR				
(Dates: 4Q, 3Q, 4Q)	30.3	29.1	27.6	+10
Taxable Sales - $ bil.	N.A.	N.A.	N.A.	
Plane Passenger Arrivals (thous.)	112.3	108.8	120.4	- 7
Petroleum Prod. (thous. bls.)	63	63	61	+ 3
Consumer Price Index				
1967=100	N.A.	N.A.	N.A.	
FLORIDA				
Personal Income-$ bil. SAAR				
(Dates: 4Q, 3Q, 4Q)	92.2	88.8	79.7	+16
Taxable Sales - $ bil.	62,629	60,684	54,481	+15
Plane Passenger Arrivals (thous.)	2980.3	2712.5	3205.6	- 7
Petroleum Prod. (thous. bls.)	114	116	116	- 2
Consumer Price Index - Miami	**MAY**	**MAR**	**MAY**	
Nov. 1977 = 100	143	140	130	+10
GEORGIA				
Personal Income-$ bil. SAAR				
(Dates: 4Q, 3Q, 4Q)	45.4	43.7	40.8	+11
Taxable Sales - $ bil.	N.A.	N.A.	N.A.	
Plane Passenger Arrivals (thous.)	1989.0	1813.0	2250.7	-12
Petroleum Prod. (thous. bls.)	N.A.	N.A.	N.A.	
Consumer Price Index - Atlanta	**APR**	**FEB**	**APR**	
1967 = 100	266	263	235	+13
LOUISIANA				
Personal Income-$ bil. SAAR				
(Dates: 4Q, 3Q, 4Q)	36.7	35.3	32.3	+14
Taxable Sales - $ bil.	N.A.	N.A.	N.A.	
Plane Passenger Arrivals (thous.)	298.7	292.7	315.6	- 5
Petroleum Prod. (thous. bls.)	1,169	1,168	1,266	- 8
Consumer Price Index				
1967 = 100	N.A.	N.A.	N.A.	
MISSISSIPPI				
Personal Income-$ bil. SAAR				
(Dates: 4Q, 3Q, 4Q)	17.0	16.5	15.9	+ 7
Taxable Sales - $ bil.	N.A.	N.A.	N.A.	
Plane Passenger Arrivals (thous.)	38.1	35.7	45.0	-15
Petroleum Prod. (thous. bls.)	96	96	109	-12
Consumer Price Index				
1967 = 100	N.A.	N.A.	N.A.	
TENNESSEE				
Personal Income-$ bil. SAAR				
(Dates: 4Q, 3Q, 4Q)	37.0	35.8	33.2	+11
Taxable Sales - $ bil.	N.A.	N.A.	N.A.	
Plane Passenger Arrivals (thous.)	156.7	150.9	173.3	-10
Petroleum Prod. (thous. bls.)	N.A.	N.A.	N.A.	
Consumer Price Index				
1967 = 100	N.A.	N.A.	N.A.	

	MAY 1981	APR 1981	MAY 1980	ANN. % CHG.
UNITED STATES				
Agriculture				
Prices Rec'd by Farmers				
Index (1967=100)	260	261	228	+14
Broiler Placements (thous.)	85,570	85,593	81,693	+ 5
Calf Prices ($ per cwt.)	69.00	70.70	74.50	- 7
Broiler Prices (¢ per lb.)	28.2	26.8	23.6	+19
Soybean Prices ($ per bu.)	7.59	7.33	5.71	+33
Broiler Feed Cost ($ per ton)	235	254	189	+24
SOUTHEAST				
Agriculture				
Prices Rec'd by Farmers				
Index (1967=100)	267	261	231	+16
Broiler Placements (thous.)	33,714	33,692	31,657	+ 6
Calf Prices ($ per cwt.)	61.13	67.08	69.91	-13
Broiler Prices (¢ per lb.)	26.6	25.6	22.5	+18
Soybean Prices ($ per bu.)	7.36	7.50	5.81	+27
Broiler Feed Cost ($ per ton)	228	229	181	+26
ALABAMA				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: FEB, FEB)	283		315	-10
Broiler Placements (thous.)	10,884	11,077	10,343	+ 5
Calf Prices ($ per cwt.)	61.00	63.60	66.70	- 9
Broiler Prices ($ per lb.)	26.5	24.5	21.5	+23
Soybean Prices ($ per bu.)	7.24	7.43	5.82	+24
Broiler Feed Cost ($ per ton)	240	245	169	+42
FLORIDA				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: FEB, FEB)	872		847	+ 3
Broiler Placements (thous.)	1,917	1,897	1,782	+ 8
Calf Prices ($ per cwt.)	64.90	69.60	73.10	-11
Broiler Prices (¢ per lb.)	26.0	25.5	22.0	+18
Soybean Prices ($ per bu.)	7.24	7.43	5.82	+24
Broiler Feed Cost ($ per ton)	240	240	205	+17
GEORGIA				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: FEB, FEB)	395		375	+ 5
Broiler Placements (thous.)	13,098	12,808	12,224	+ 7
Calf Prices ($ per cwt.)	58.50	60.60	64.90	-10
Broiler Prices (¢ per lb.)	26.0	25.5	22.5	+16
Soybean Prices ($ per bu.)	7.33	7.39	5.91	+24
Broiler Feed Cost ($ per ton)	220	220	186	+18
LOUISIANA				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: FEB, FEB)	258		227	+14
Broiler Placements (thous.)	N.A.	N.A.	N.A.	
Calf Prices ($ per cwt.)	61.00	65.50	67.10	- 9
Broiler Prices (¢ per lb.)	28.0	26.0	24.0	+17
Soybean Prices ($ per bu.)	7.59	7.65	5.87	+29
Broiler Feed Cost ($ per ton)	245	245	190	+29
MISSISSIPPI				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: FEB, FEB)	315		319	- 1
Broiler Placements (thous.)	6,443	6,292	5,970	+ 8
Calf Prices ($ per cwt.)	60.10	69.10	74.80	-20
Broiler Prices (¢ per lb.)	27.0	27.5	24.0	+13
Soybean Prices ($ per bu.)	7.35	7.45	5.74	+28
Broiler Feed Cost ($ per ton)	220	215	183	+20
TENNESSEE				
Agriculture				
Farm Cash Receipts - $ mil.				
(Dates: FEB, FEB)	278		295	- 6
Broiler Placements (thous.)	1,373	1,351	1,338	+ 3
Calf Prices ($ per cwt.)	62.00	65.80	75.10	-17
Broiler Prices ($ per lb.)	29.0	25.0	22.0	+32
Soybean Prices ($ per bu.)	7.20	7.50	5.84	+23
Broiler Feed Cost ($ per ton)	215	215	179	+20

Notes:
Personal Income data supplied by U. S. Department of Commerce. Taxable Sales are reported as a 12-month cumulative total. Plane Passenger Arrivals are collected from 26 airports. Petroleum Production data supplied by U. S. Bureau of Mines. Consumer Price Index data supplied by Bureau of Labor Statistics. Agriculture data supplied by U. S. Department of Agriculture. Farm Cash Receipts data are reported as cumulative for the calendar year through the month shown. Broiler placements are an average weekly rate. The Southeast data represent the total of the six states. N.A. = not available. The annual percent change calculation is based on most recent data over prior year.

Table 4
Business Lending By Commercial Banks
November 3-8, 1980

	1-24	25-49	50-99	100-499	500-999	1000 and over
Short term commercial and industrial loans						
Amount of loans	5.6%	4.2%	4.3%	13.9%	5.1%	67.0%
Number of loans	70.5%	12.6%	7.0%	7.6%	.8%	1.5%
Weighted average maturity (months)	3.0	3.5	2.9	3.0	3.4	1.7
Percentage of loans						
a. with floating rate	25.0%	27.9%	40.7%	52.1%	68.3%	53.0%
b. made under commitment	25.1%	22.3%	35.3%	46.4%	65.6%	48.0%
		1-99		100-499	500-999	1000 and over
Long term commercial and industrial loans						
Amount of loans		9.7%		18.1%	5.4%	66.7%
Number of loans		83.7%		12.5%	1.4%	2.4%
Weighted average maturity (months)		48.3		34.4	40.6	49.6
Percentage of loans						
a. with floating rate		39.3%		29.5%	72.3%	85.5%
b. made under commitment		29.0%		25.1%	70.2%	70.3%

Source: U.S. Board of Governors of the Federal Reserve System. **Federal Reserve Bulletin**, February 1981, p. 1424.

Interbusiness financing also occurs via cash loans, provision of equipment and supplies, and equipment financing. Although no data are available on the first two of these sources, financing or equipment purchases by equipment manufacturers is known to be an important method of fixed asset financing.

Commercial banks, finance companies, and leasing companies are the most important financial institutions to small business. Small issuance size makes direct access to the debt markets via marketable bonds and commercial paper, and access to life insurance company private placements unlikely in all but a few cases. Thus, small business must rely on banks, finance companies, and leasing companies for much of their discretionary financing.

"The result is a sort of intermediation where small firms borrow from large firms through trade credit, and large firms in turn finance themselves in the credit markets."

Table 4 provides data on the business lending of commercial banks.[2] Loans to small business are large in number but much smaller in dollar terms. At least to some extent this reflects the disproportionate size of large businesses relative to their number. Small business loans are also more likely to be fixed rate and less likely to be made under commitments than for large business.

Competition to banks from finance companies has become keener. The historical differences in riskiness of client have been blurred in recent years as banks have accepted more risk and finance companies have intensifed efforts to attract lower risk firms. Furthermore, both banking organizations and finance companies have expanded product lines. The importance

[2]Although the data are arranged by size of loan, and not by the size of the borrower, loan size and firm size should be highly correlated.

Table 5
Lease Financing by Type of Organization

	Closely Held Corp.	Publicly Traded Corp.	Bank Division or Subsidiary	Subsidiary of Bank Holding Company	Other
Average Original Lease Receivable:					
less than $10,000	20%	17%	4%	—	14%
$10,000-$50,000	53	35	32	52%	41
$50,000-$250,000	15	26	55	39	27
over $250,000	12	22	9	9	18

Source: "Survey of Accounting and Business Practices, 1979" American Association of Equipment Lessors, Washington, D.C.

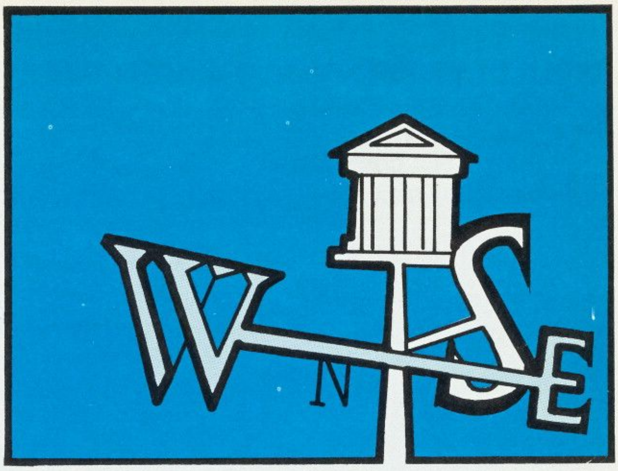
of this to small business is that the finance companies offer a broad array of products, many of which are suitable to small business. Examples include: automobile, commercial vehicle, equipment, accounts receivable, and inventory financing. And, the increased competition broadens market choice. To be sure, banking organizations are fighting back via finance subsidiaries and asset based lending groups. However, it will not be surprising if the finance company market share of small business loans increases.

Further evidence of the existence of nontraditional funds sources to small business appears in the lease finance data in Table 5. This exhibit clearly indicates that leases are made in small sizes as well as large, and that the size of lease differs.

"... it will not be surprising if the finance company market share of small business loans increases."

To summarize, small business relies on debt financing to a greater extent than equity. Debt is provided both from other businesses and financial institutions. Thus, while commercial banks are an important source of discretionary borrowing, they are not the only, and indeed not even the major, source of debt financing. Of course, this conclusion must be tempered by the fact that it is often difficult to trace funds flows. For example, individuals may borrow using personal consumer or mortgage credit and inject those funds into a business. Nonetheless, competition from other financial institutions and interbusiness financing makes clear the fact that commercial banks do not monopolize small business finance. ER

—*Peter Eisemann*
Victor L. Andrews



Nonlocal Competition for Banking Services

Arnold A. Heggestad, Chairman, Department of Finance, Insurance, and Real Estate, University of Florida (and Visiting Scholar at the Federal Reserve Bank of Atlanta), notes that nonlocal competition is only growing in selected markets. But whether this expansion is a response to real economies or simply a result of regulatory treatment is a question for further research.

How will competition from outside the local area affect banking markets? We have little evidence at present, even though nonlocal competition is undeniably here. Several basic issues need study.

I define nonlocal competition as banking-related activity in a market by banks headquartered in other cities. The primary concern, however, is the study of banks operating across state and national borders. This public policy area requires intensive study of its current importance, its current effects on market performance, and its potential for future growth.[1]

The ultimate impact on nonlocal competition is on market performance. As nonlocal competition increases, all firms may compete more intensely with resulting lower loan rates, better service, and higher rates for deposit funds. In addition, the efficiency of financial intermediation may be improved by increasing the linkage between markets, thus allowing for a more responsive allocation of credit.

"Nonlocal competition appears to be a growing phenomenon in only a subset of financial markets."

The McFadden Act and the Douglas Amendments to the Bank Company Act prohibit banks from crossing state lines to conduct a full commercial banking business. However, banking organizations can conduct numerous activities that are not legally restricted. These range from calling on potential loan customers to the establishment of specialized facilities in the target markets. The most common form of entry has been to establish subsidiaries of bank holding companies which are aimed at specialized financial markets. Generally, they are identified with the parent financial institution.

1. The current degree of nonlocal competition has recently been studied by Peter Merrill Associates, **The Environment for Nonlocal Competition in U.S. Banking Markets**, American Bankers Association, 1981.

TABLE 1. MAJOR NON-LOCAL ACTIVITIES BY FUNCTION AND BY CLIENT TYPE

MARKET TYPE / MAJOR FUNCTION	CONSUMER (RETAIL) MARKET	CORPORATE MARKET	BOTH CONSUMER AND CORPORATE	FINANCIAL INSTITUTIONS
Lending	Credit Cards Industrial Banks Consumer Finance Companies	Corporate Calling Officers Loan Production Offices Edge Act Corporations → 1 Factors Mortgage & Real Estate Companies Industrial Finance Companies Mortgage Banking Companies	Mortgage & Real Estate Companies	Corporate Calling Mortgage Banking Companies Correspondent Services
Deposit-Taking	4 2 Industrial Banks 3	Edge Act Corporations → 1		Correspondent Services
Fee Income Producing	Travelers Checks Investment Advisory Firms	Leasing Companies	Trust Companies	Correspondent Services

Source: Peter Merrill Associates, **The Environment for Nonlocal Competition in U.S. Banking Markets**, American Bankers Association, 1981.

1. Edge Act Corporations, while aimed primarily at corporations engaged in import and export, have the potential for dealing with individuals engaged in these activities or domiciled outside the U.S.
2. Consumer Finance Companies in some states can issue "thrift certificates" or similar debt instruments; insurance must be provided locally, by private or quasi-public (but non-FDIC) means.
3. Travelers checks, by generating float, have a deposit-like characteristic.
4. If and when banks are allowed to pay interest on credit balances, credit cards become a "deposit" instrument.

Nonlocal competition appears to be a growing phenomenon in *only a subset of financial markets.* Generally, these markets all share three characteristics — large size, the existence of specialized submarkets, and growth potential. Characteristically, entry is most common in markets where there is a regulatory advantage to operating within the market.

Why is Non-Local Competition Expanding?

It is clear that all dimensions of banking competition have increased in recent years. Nonlocal competition is no exception. Several major developments have led to increases in the amount of nonlocal competition in the past decade. First, the economy has experienced shifts in relative growth rates. Banks that are headquartered in the industrial Northeast have not grown relative to banks operating in the Sunbelt and the energy states. Thus, there has been an incentive for banks to obtain a presence in rapidly growing markets. Second, states have treated their financial institutions quite differently. In some states, tax, branching, and usury laws are more favorable.* Third, technology now permits operations in a wide geographic area. Communications systems and travel have made it feasible to maintain a geographically-dispersed operation.

The McFadden Act will in all likelihood be removed or amended within the next several years. This has had a differing impact on the desire to diversify into new markets. For regional banks, uncertainty on McFadden has delayed their geographic expansion. Their preferred form of expansion will be through acquisition of existing banks in other states. At the same time, many money center banks fear they will be forbidden to enter desirable markets by aquisition. Thus, they have used other devices to enter these markets, even some that may not be profitable in the short run. This approach at least gives a presence in many markets.

Potential Impact

Nonlocal competition has accelerated in intensity and importance. However, relative to other changes in competition, nonlocal would only rank third. The thrift institutions have obtained new powers to compete directly with banks. Additionally, nondeposit companies ranging from insurance and credit card companies to money market funds have had tremendous growth in many markets. In both cases, their impacts have exceeded the impact of the presence of out-of-state banks.

"... money center banks maintain capital to asset ratios substantially lower than most regional banks. As a result, they can maintain a lower operating margin with lower loan rates or higher deposit rates than regional competitors."

The most important element of change in nonlocal competition is the impact it will have on market performance. As out-of-state banks enter, there will be an increase in the number of firms competing within the market. Additionally, there will be a substantial increase in competition for specialized functions. For example, there may be within any market only a few firms involved in international lending. This number would be increased substantially by Edge Act companies (internationally-oriented banking subsidiaries usually located outside a bank's own state). The result should be better performance with respect to interest rates, other fees, and services.

This element of performance raises a very serious question, however. Are the increases in competition due to greater efficiency, i.e., real

TABLE 2. NUMBER OF APPLICATIONS APPROVED FOR OUT-OF-STATE BANK - RELATED ACTIVITIES FOR BANK HOLDING COMPANIES.

June 1, 1971-December 31, 1977[1]

Activity	Acquisition of Existing Businesses	De Novo	Total
Finance Company (Commercial, Consumer, Insurance Premium, Mobile Home, and Agricultural)	73	436	509
Insurance	44	202	246
Mortgage Banking	30	172	202
Real and Personal Property Leasing	14	102	116
Investment Services	5	28	33
Factoring	5	24	29
Industrial Banking	3	18	21
Data Processing	2	19	21
Trust Operations	6	11	17
Community Welfare Investments	0	2	2
Miscellaneous	8	7	15
TOTAL	190	1,021	1,211

[1]The figures in this table are intended to indicate the approximate magnitude and relative importance of out-of-state expansion by bank holding companies in various bank-related fields. However, the figures are likely to be understated in several respects. An application to acquire an existing company, or notification of intention to expand *de novo*, may involve expansion of services at several locations, only one of which would be listed in the Federal Reserve announcement and hence would be included in these figures. Also, in some cases, an application to engage in two or more activities may have been recorded only once, as if it were an application for one activity.

Source: Golembe Associates, "A Study of Interstate Banking by Bank Holding Holding Companies, Prepared for Association of Bank Holding Companies, May 1979.

economies, or are they simply due to "pecuniary" economies; specifically, more favored regulatory treatment. For example, money center banks maintain capital to asset ratios substantially lower than most regional banks. As a result, they can maintain a lower operating margin with lower loan rates or higher deposit

"As state boundaries are broken down by de facto banking, the larger banks are likely to increase their share relative to smaller banks."

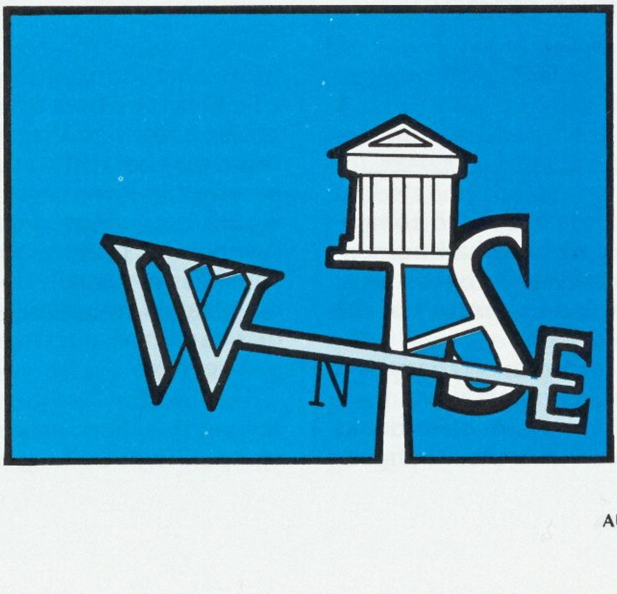
rates than regional competitors. This gives them an advantage. It improves the performance within that market but at some cost in competitive equity.

There are additional elements of performance relating to changes in the structure. This has been studied within states but, since this phenomenon is quite new, never across states. First, the increases in nonlocal competition will have some implications for overall concentration of resources. As state boundaries are broken down by de facto banking, the larger banks are likely to increase their share relative to smaller banks. The second factor is the increase in the number of links between markets. Banks will now be meeting in many more markets; this may affect how much they are willing to compete in any single market.

An additional performance implication of this trend is the effect on intermediation. Will the presence of subsidiaries operating in markets facilitate the coordination of borrowers and lenders? Will the private market, operating through its own decision process, be more efficient than existing financial markets?

Finally, nonlocal competition by necessity is carried out through indirect means. Within a rapidly growing market there may be loan production offices that offer commercial loans, Edge Act companies that deal in international transactions, and consumer finance companies that only make consumer loans. Would the system be more efficient if all these services were collapsed into basically diversified commercial banking firms? This area is critical for future policy. ER

—Arnold A. Heggestad



Performance Implications of New Competition

Duane B. Graddy, Associate Professor, Department of Economics and Finance, Middle Tennessee State University, focuses on the basic definitions of "banking markets" and "cluster of services" under deregulation. New entry by thrifts, particularly into smaller banking markets, Graddy predicts, may not necessarily produce lower prices and greater efficiency.

Recent legislative reforms and an array of financial innovations have drastically altered the competitive relationship among financial intermediaries. Traditional banking-type services are now offered by mutual savings banks, savings and loan associations, credit unions, investment companies, brokerage firms, and even some large retailers. As these institutions realize their full competitive potential, substantial restructuring is likely to occur in local financial markets. Economic theory suggests that this restructuring process will affect market performance (the overall function and efficiency of the market).

This restructuring process begins with the granting of the new powers and proceeds to changes in the number and/or size distribution of competing institutions and finally to new rivalries among those institutions. Traditionally, regulators have differentiated commercial banks from other financial institutions by the specific "cluster of services" they offered. But what is the "market"? Do banks compete only with other banks? Should thrift institutions be included in the definition of the banking market? What about money market funds? Can we even define a geographic market? Or, is it necessary to unbundle the entire cluster of banking services and develop a series of product markets which encompass various geographic regions? It is my feeling that the "cluster of services" paradigm is still applicable to the small market setting.

The nature of market rivalry determines prices and profits within local banking markets as well as the other performance dimensions (efficiency, stability, innovation, and equity).

"Can we even define a geographic market?"

For example, the successful entry of savings and loan associations into consumer installment lending could lower borrowing costs, increase loan output, reduce interest margin variability, produce innovative changes in loan contracts, and/or create greater equity in the distribution of personal loans. On the other hand, the conduct of banks already offering consumer installment loans would not change if they had already established an effective barrier to entry.

Will More Competitors Mean Lower Prices?

Entry of thrift institutions into previously prohibited areas has the potential for reducing market concentration (increasing the number of competitors). Whether this change in market structure actually improves market performance, however, depends on several factors.

1. The first is the relationship between concentration and bank behavior. Are the performance dimensions (efficiency, stability, etc.) affected by the degree of local market concentration?
2. Second, have other nonbank intermediaries offered substitute products in the past? For example, bank response to the newly granted consumer lending powers is likely to vary considerably between markets where credit unions and finance companies have been active and where they have not.
3. Third, to what extent will thrifts choose to diversify into banking activities, and to what extent will the public perceive them as "full service banks." Can thrifts overcome the barrier of long-standing customer relationships and the wide menu of services offered by commercial banks? Even small banks can represent formidable competitors in this respect, particularly if they are affiliated with a large banking holding company (BHC). This brand-image problem may represent one of the most important hurdles facing thrift entrants.[1]

Many local banking markets, particularly rural markets, are characterized by high levels of deposit concentration.[2] Moreover, studies show that for two of the new thrift services, auto loans and checking accounts, the level of concentration is often high enough to allow suppliers to act together as a monopoly.[3] Bank interdependence in these markets is pervasive enough that profits are spread evenly over all competitors, and there is little or no incentive to lower prices for these services.

At the other extreme, there are few markets for these services in which the prices do not fall when concentration declines. Allowing thrift institutions to enter these product-lines appears to be an unambiguous way of benefiting consumers. However, this may not happen in every market. For example, thrift entry in a highly concentrated market may not lower the level of concentration enough to promote competitive pricing; thus it may have no long-term impact on service prices. Initial entry could create a flurry of different pricing patterns, but in the long-run, the market would return to a shared monopoly.

Pricing Strategy

On the other hand, product prices may decline if established banks lower their prices to a level that would make new entry unprofitable. To overcome the initial identity barrier, thrifts may have to spend heavily for advertising and physical facilities. Where mutual interdependence is high, established banks can discourage thrift entry by charging a price below that necessary to cover penetration costs.

". . . product prices may decline if established banks lower their prices to a level that would make new entry unprofitable."

Through such a strategy, banks could undermine the ability of thrifts to establish lasting customer relationships as well. The failure to offer even some marginal service could destroy the "department store" effect. In cases where concentration is reduced below the effective monopoly level or where the market is not effectively monopolized, we would expect the entry of nonbank competitors to increase consumer welfare by lowering service prices.

[1] Studies show that firm entrenchment based on close customer relationships and variety of services inhibits concentration changes in local banking markets. See B. Frank King, "Changes in Seller Concentration in Banking Markets," **Working Paper Series**, Federal Reserve Bank of Atlanta, 1977.

[2] In this context, "banking market" refers to counties and SMSAs.

[3] Arnold A. Heggestad and John J. Mingo, "The Competitive Condition of U.S. Banking Markets and the Impact of Structural Reform," **Journal of Finance**, June 1977.

The granting of the new thrift powers presents a rare opportunity to analyze the price adjustment process among financial institutions in markets with different initial concentration levels. Do prices converge to a uniform level over time? If so, what market interactions produce the convergence? Rigorous competition? Tacit collusion? Price leadership? (One large competitor sets the price and the rest follow.) Will commercial banks' inherent advantage as the earliest full-service institutions produce a permanently fragmented price structure with the new competitors unable to overcome the banks' advantage? Banks have an accumulated stock of advertising and goodwill created over many years of full service operation. Does the process change if BHCs are present in the market? Recent evidence indicates that BHCs may reduce market rivalry.[4] So market consolidation could be detrimental to performance.

Nonprice Strategy

Nonprice competition (advertising, banking hours, gifts, etc.) is likely to intensify during the transition phase of the deregulation process for several reasons. First, price constraints still exist on certain services, such as time and savings deposits. The "premium controversy," which centers on whether premiums are an awkward and inefficient way to compete, attests to this. State usury laws on credit card loans may be prohibitive as well. Second, establishing the full-service image may require large promotional expenditures by S&Ls and credit unions. Third, given the more liberal branching status of thrifts in some areas, pre-emptive entry could be viewed as a way of forestalling future bank expansion. As deregulation proceeds and we move toward explicit pricing, the flow of resources may be redirected from promotional activities to production. However, even this is not clear. Consolidation within the financial services sector brought about by deregulation could produce a structure similar to that in other oligopolistic industries where prices are rigid and competition is on a nonprice basis.

A final consideration is the influence of market concentration on the risk/return trade-off in banking. The rate of return on bank assets is higher in concentrated markets than in less concentrated ones.[5] Moreover, bank managers tend to become more conservative as concentration increases. The result is that they reject more risky consumer loans, mortgages, and small business loans. At least one study, however, provides evidence that nonbank competition may reduce this conservatism.[6]

Increased competition may also influence the risk/return behavior of the banking firm by altering the costs and relative composition of the funding mix. Banks in concentrated markets exercise their monopsony power (the power of being one of few buyers in a market) by paying lower deposit rates and substituting demand deposits and passbook savings for other sources of funds.[7] The earnings squeeze caused by increased competition from thrifts and extra-market institutions could weaken the capital base of these firms. The deposit structure's interest sensitivity is a problem for all institutions. Banks affiliated with holding companies may fare somewhat better since they can rely on the financial strength of the consolidated organization. ER

—Duane B. Graddy

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[4]Stephen A. Rhoades and Roger D. Rutz, "Impact of Bank Holding Companies on Competition and Performance in Banking Markets," **Staff Studies**, Board of Governors of the Federal Reserve System, 1979.

[5]Arnold A. Heggestad, "Market Structure, Risk, and Profitability in Commercial Banks," **Journal of Finance**, September 1977.

[6]Donald R. Fraser and Peter S. Rose, "Banking Structure and Performance in Isolated Markets: The Implications for Public Policy," **Antitrust Bulletin**, Fall 1972.

[7]Duane B. Graddy and Reuben Kyle, "The Simultaneity of Bank Decision-making, Market Structure, and Bank Performance," **Journal of Finance**, March 1979.

Savings and Loan Associations in the New Financial Environment

James A. Verbrugge, Professor and Chairman, Department of Banking and Finance, University of Georgia, suggests that regulators need to be looking for alternatives to merging troubled thrifts with healthier institutions. In the longer run, more research is needed on questions of capital adequacy, interest rate risk, and maturity imbalances in the new environment.

The implications of the Deregulation Act for thrift institutions are both serious and sweeping. The pessimistic view is that the Deregulation Act has signaled the beginning of the end for the S&L industry. A more optimistic view is that the Deregulation Act represents the demise of the industry as we know it, but also represents the threshold of a new era of opportunities for thrift institutions.

Without rehashing past history, it is clear that the Deregulation Act was the final product of a long series of financial reform efforts over the past fifteen years.[1] Pressures to reform the financial system intensified after Regulation Q was extended to thrift institutions in 1966. These pressures originated from a variety of sources and for a variety of reasons, some of which were the realization that Regulation Q discriminates against small savers, the recognition of the problems created by the maturity imbalance of thrift institutions in an era of volatile and upward trending interest rates, and the development of innovations in the financial markets (e.g., money market mutual funds). Previous efforts at reform were piecemeal: the development of longer-term CDs for thrifts in the early 1970s, the introduction of the MMC in 1978, the regional experiments with NOW accounts, and the use of variable rate mortgages on a limited geographic basis. It was inevitable that legislation similar to the Deregulation Act would be passed. The issue was not if, but when.

"It is quite clear that the S&L industry was extremely short-sighted in its efforts to prevent true financial reform."

It is quite clear that the S&L industry was extremely short-sighted in its efforts to prevent

[1] These earlier proposals include, for example, the Friend Study, the Hunt Commission Report, the Financial Institutions Act, the FINE Study, and the Financial Reform Act.

true financial reform. For many years (and to some extent, even now), the major thrust of the industry was to preserve Regulation Q and the differential at all costs. Had the industry been willing to give up Regulation Q for additional meaningful powers at an earlier date, it now would be far better equipped to deal with the problems it faces in the current volatile financial environment.

However, this is all history. The relevant questions now concern the effects of the deregulation and the implementation of broader powers provided for thrifts by the Deregulation Act.

What is outlined below is not intended to be an exhaustive list of questions but merely some which appear to be most important. The questions are divided into two categories; (1) those associated with the period of transition and (2) more fundamental, long-run effects of the Deregulation Act on thrifts. While the latter issues are clearly of greater academic and intellectual interest, the former will determine whether or not the thrift industry will survive to share in the benefits of less regulated financial markets.

The Period of Transition

The most immediate and important issue facing S&Ls and the regulatory agencies is how to deal with the critical problems facing thrifts during the period of transition to the deregulated environment envisioned by the legislation. The basic problem is that the liability side of S&Ls has already become quite interest-rate sensitive as a result of the rapid growth of six month MMCs and jumbo CDs, and is likely to become more sensitive as decontrol of deposit rates progresses over the next several years. On the asset side, however, the benefits of deregulation and broadened powers will accrue slowly over a relatively long period of time. For most S&Ls, the portfolios are dominated by fixed-rate-mortgages, many of which carry yields considerably below prevailing market rates on funds. In many cases, the yield-cost spread for individual associations is negative. As a result, unless associations have a substantial amount of liquid assets whose yields have kept pace with the cost of funds, profits are near zero or negative. For those associations with healthy net-worth positions, this is a painful but not terminal problem. For those associations with minimum capital positions, there is a real danger of failure in this situation. Several important policy questions arise from this issue.

1. What should be the policy of the regulatory agencies toward associations in real danger? Of course, the best solution is that the current efforts to reduce inflation succeed and that interest rates, particularly short-term rates, fall. Should this occur, the earnings squeeze would dissipate quickly over several quarters as MMCs are rolled over at lower rates.

"The basic problem is that the liability side of S&Ls has already become quite interest-rate sensitive . . . (while) on the asset side . . . the benefits of deregulation will accrue slowly . . ."

In the absence of interest-rate decreases, a serious question remains. What should be the policy of the FHLBB and the FSLIC toward problem and near-failure associations? Should we allow failures which are not the result of poor management or fraud but are the result of interest-rate risk which has been imposed on the institutions due to regulatory constraints? Or, should there be some sort of assistance to associations which find themselves in this situation? The approach taken thus far has been to merge troubled S&Ls with healthier associations. In a number of cases, the FSLIC absorbed assets (approximately $1.3 billion in 1980) of extremely weak associations. Other measures under consideration include further changes in net worth requirements and the use of the FSLIC as a source of capital for troubled thrifts.[2]

[2] The suggestion of the FSLIC as a source of capital originated in a paper by Verbrugge and Dince (1979). Ironically, the idea was never intended as a source of capital for weak and troubled S&Ls. It was suggested as a means of raising capital, primarily for mutuals, who were experiencing temporary net-worth difficulties due mostly to rapid growth.

2. Is there any danger of a loss of public confidence in S&Ls as a result of the troubled situation in the thrift industry? No insured S&L depositor has ever experienced a loss. However, with the seriousness of the earnings squeeze and the publicity given to the troubles of thrifts, there is the possibility of some loss of public confidence in thrifts.

Longer-Run Issues

Assuming that the thrifts and regulators muddle through the transition period without disastrous results, there are a number of more fundamental questions regarding thrifts and the new financial environment.

Models of S&L Behavior Under Deregulation

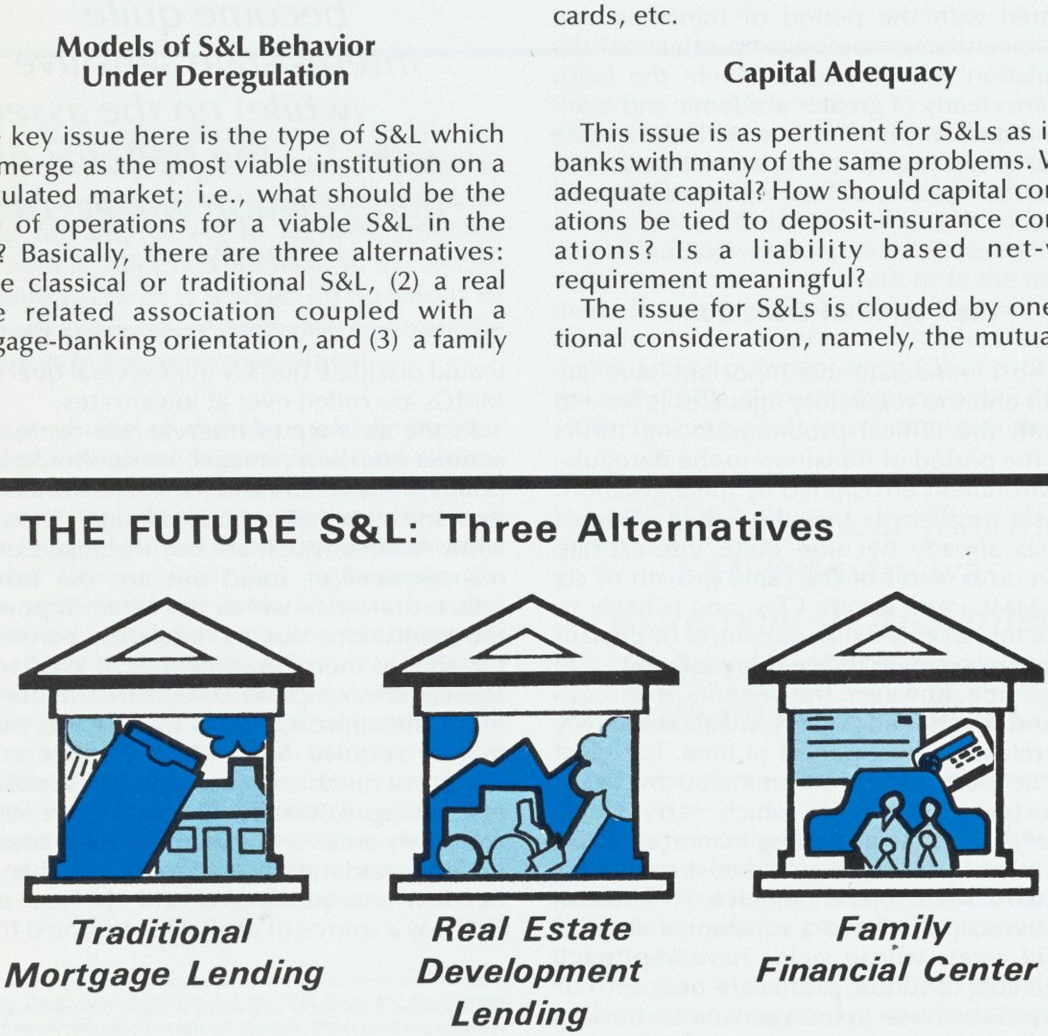
The key issue here is the type of S&L which will emerge as the most viable institution on a deregulated market; i.e., what should be the mode of operations for a viable S&L in the 1980s? Basically, there are three alternatives: (1) the classical or traditional S&L, (2) a real estate related association coupled with a mortgage-banking orientation, and (3) a family financial center. The first would be a business-as-usual S&L concentrating on deposit acquisition and traditional mortgage lending. In all likelihood, this type of operation is doomed to extinction. The second type would be heavily oriented toward real estate development loans with only a moderate role for residential lending. Service corporations would play an important role in this type institution. In addition, the association would focus on mortgage banking activity by originating, buying, selling, and servicing loans instead of originating mortgages for its own portfolio. The third type would become a one-stop consumer finance supermarket with a full range of consumer services including consumer and mortgage loans, transactions accounts, traditional deposits, credit cards, etc.

Capital Adequacy

This issue is as pertinent for S&Ls as it is for banks with many of the same problems. What is adequate capital? How should capital considerations be tied to deposit-insurance considerations? Is a liability based net-worth requirement meaningful?

The issue for S&Ls is clouded by one additional consideration, namely, the mutual form

THE FUTURE S&L: Three Alternatives



of organization. Currently, mutuals can obtain additional capital only through retained earnings from profits. The only option for obtaining additional capital is to convert to the stock form of organization, a movement which is occurring at a rapid rate. Other options, like mutual capital certificates, appear to have limited usefulness.[3]

Managerial Motives and the Mutual vs. Stock Issue

Several recent banking studies have questioned the traditional assumption of profit maximization in banking under conditions of monopoly power.[4] In other words, banks with monopoly power may reward the management instead of stockholders by hiding profits under salaries and prerequisities (a tendency known as "expense-preference").

Similar questions can be raised concerning S&Ls with market power. In addition, since mutuals do not have traditional owners, there is some question regarding the motivation of mutual managers. Unlike stock institutions, mutual associations do not necessarily make a profit. Following the lines of banking studies, several recent papers have addressed the stock-mutual question.[5]

In these studies, it was found that mutual S&Ls exhibit expense-preference tendencies and that they also tend to have preference toward lower risk portfolios. Further efforts in this area are warranted.[6]

Interest Rate Risk Management in S&Ls

The basic financial management issue facing S&Ls is, of course, how to manage interest-rate risk. In the current financial environment, interest-rate intermediation (the process by which an institution takes deposits and invests them, in this case involving short-term liabilities and long-term assets) is extremely risky. As outlined above, the family financial center S&L and the mortgage banking S&L models do reduce some of the interest-rate risk by selling loans instead of retaining them in the portfolio and by engaging in shorter-term consumer lending. However, long-term mortgage lending and short-term deposit acquisition are still important features in both models. Unless variable-rate mortgages are issued which allow changes in rates very frequently, S&Ls will still face considerable interest-rate risk.

"Will the regulatory agencies be able to resist the temptation to continue their role as protectors and supporters of the industries they serve?"

The question then becomes how to deal with the remaining interest-rate risk and maturity imbalance. One alternative is the use of the financial futures market in which the institution could hedge its exposure to interest-rate risk. Traditional use of the interest-rate futures market has emphasized the process of hedging against the rate movement of a specific asset or liability.[7]

More recently, it has been suggested that the optimal approach is the maturity-imbalance hedge which is simply a hedge of the overall maturity imbalance risk exposure of the firm.[8]

There is an obvious need for considerable research regarding the role of interest-rate futures in thrift-institution management.

Miscellaneous Issues

There are, of course, numerous other questions and issues which can be raised regarding

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[3]The capital issue for S&Ls is considered in detail in Verbrugge and Dince (1979) and Verbrugge and Dince (1980).

[4]For example, see Edwards (1977) and Edwards and Heggestad (1973).

[5]Verbrugge and Goldstein (forthcoming 1981), Verbrugge and Jahera (1979), and Taggart (1978).

[6]Perhaps some additional light on this issue can be obtained from recent work on agency theory. Jensen and Meckling (1976) and Fama (1980).

[7]Schweser, Cole, and D'Antonio (1980).

[8]The maturity-imbalance hedge is a short position whose function is to offset the volatility of the firm's profitability. For a complete explanation see Riordan and Hartzog (1980) and Hartzog (1981). The paper by Thygerson (1980) also contains useful material regarding hedging with interest-rate futures.

thrifts in the post-Deregulation Act world. To list several —

• Will the FHLBB, and other regulatory agencies, be able to resist the temptation to continue their role as protectors and supporters of the industries they serve? Or, will they be able to reverse past patterns and espouse a market-oriented regulatory philosophy?

• What is the appropriate merger policy in the new environment? Inevitably, the question of bank and S&L mergers must be addressed as well.

• The structure of both the banking and S&L industry is likely to undergo significant change as the effects of the Deregulation Act and other aspects of deregulation (breaking down of geographic barriers) are fully realized. As a result, it will be important to study the effects of these changes on market concentration and the performance of financial institutions. Furthermore, most studies have failed to account for inter-industry competition. As competition between banks and S&Ls intensifies, this issue can no longer be ignored.

• How beneficial are equity participations (shared appreciation) loans to thrifts and to borrowers? Is there a role for a traditional lender in a market where equity financing may take on increased importance?

Conclusion

There is no doubt that price competition between banks and thrifts will intensify over the next decade in both funds acquisition and lending. The basic questions are whether thrifts have been given the necessary flexibility to compete effectively in this market and whether thrift managers will implement the new powers successfully. The heightened competition appears certain to weed out inefficient firms, improve the efficiency of survivors, and leave consumers better served. ER

—James A. Verbrugge

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The Effects of the Deregulation Act and Potential Geographic Deregulation on the Safety and Performance of Depository Institutions

Joseph F. Sinkey, Jr., Associate Professor, Department of Banking and Finance, University of Georgia, discusses the importance of capital sources and the need for a fresh regulatory approach to capital adequacy. New expectations and new measures of safety and performance, he concludes, will be crucial during the transition period and beyond.

The purpose of this paper is to suggest some issues and research topics related to the current and future environment of depository institutions. The current environment is being shaped by the Deregulation Act. The future environment will continue to be shaped by the Deregulation Act as depository institutions adjust to new asset and liability powers, the phasing out of Reg Q (interest rate ceilings) and the phasing in of reserve requirements for nonmember institutions.

That environment will also be affected greatly by what happens in geographic deregulation. At the minimum, this deregulation will likely include regional banking (e.g., Georgia and Florida permitting reciprocal banking across their state lines). At the maximum, we could see the repeal of the McFadden Act (which prohibits bank expansion out-of-state) and full-blown interstate banking.

Defining and Measuring Safety and Performance

To determine the effects of the Deregulation Act and other structural changes on safety and performance, we must define these two concepts. What kind of safety and what kind of

"We could see the repeal of the McFadden Act and full-blown interstate banking."

performance should we expect from depository institutions during this transition period? While long-run research projects will have the luxury of attempting to grapple with such fundamental questions as what is risk (safety) and how to measure it, short-run projects will be concerned with more pressing matters, such as how to handle shocks to the financial system.

Safety. In the short run, sticking with the capital-adequacy notion of safety (i.e., that there be an adequate capital base to absorb foreseeable losses) would appear to be mandatory because the regulatory agencies' current operating procedures are geared to this approach. Since savings and loan associations and mutual savings banks currently are the depository institutions under the most stress (because the short-term rates they must pay for funds are currently higher than the long-term rates they receive on mortgages), they deserve the most attention. If we accept the premise that thrifts are under pressure, we need to consider two basic questions: (1) What is the likelihood of thrift failures over the next year or two? and (2) How should the FDIC (Federal Deposit Insurance Corporation) and FSLIC (Federal Savings and Loan Insurance Corporation) be prepared to handle failures?

The traditional deposit-insurance solution to insolvency or near-insolvency is to arrange an emergency merger-usually with the financial assistance of the insuring agency. Typically, a failing bank will be purchased by another bank and become a branch of the acquiring bank (a "nonpayoff failure"). This technique has worked well in the past and will continue to be an important tool in the future. However, there is some concern about the exclusive use of this technique in nonpayoff failures. A "payoff failure" is one in which the bank is closed and the insured depositors paid off. Thus, an important research topic is: are there alternative ways of rescuing weak depository institutions? Related questions would deal with issues of cross-institution (between banks and S&Ls or between stock and mutual institutions) and interstate mergers in distressed situations.

"Does the current banking environment make managers behave as if bankruptcy costs are zero?"

The issue of how to handle weak depository institutions focuses upon a *symptom.* In the regulator's traditional view of the world, "weak" is synonymous with "inadequate capital." Thus, to get at the *cause* of weak depository institutions, a *fresh* approach to the longstanding issue of capital adequacy is required. Such research should focus upon the following questions:

1. Is the regulatory standard of some capital ratio adjusted for classified assets (assets of questionable worth) the appropriate one for identifying weak institutions? Are there more dynamic criteria (earnings, for example)? Or for a larger institution, is the price of its stock a better criterion?
2. What are some practical ways for weak institutions to improve their capital position?[1]
3. What effect does deposit insurance have upon the behavior of the managers of depository institutions?[2] A related issue is: How should deposit insurance be priced? If the pricing of deposit insurance leads managers to attempt to maximize debt, then part of the problem of inadequate capital can be traced to the pricing of deposit insurance. In other words, does the current banking environment make managers behave as if bankruptcy costs are zero?
4. How effective is the Uniform Interagency Bank Rating System as a screening mechanism for identifying problem institutions?
5. Since the market is a better regulator than any banking agency, why isn't the market information used to monitor the riskiness of depository institutions whose shares are actively traded on major stock exchanges?[3]

Performance. The traditional structure-conduct-performance paradigm (the idea that the number and size of competing institutions is the most important determinant of a market's efficiency) is an appropriate vehicle for modeling and measuring the impact of the Deregulation Act and geographic deregulation.[4] The structural changes that have occurred and are expected to occur in the future will have a significant impact upon the conduct and performance of depository institutions. An important research issue is to determine how these structural changes will affect market concentration and performance both in the short run and

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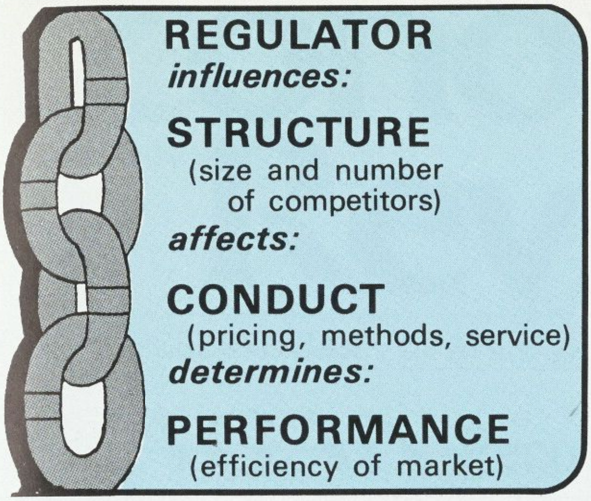
[1] See Verbrugge and Dince (1980) for some suggestions on how to handle the capital problems of S&Ls.

[2] Employing Modigliani-Miller theorems, Kane (1981) argues that S&L managers might be content with negative "bookable" net worth. Kane's analysis is based upon a model of FDIC pricing behavior developed by Buser, Chen, and Kane (1981).

[3] See Pettway and Sinkey (1980) for an early-warning model that employs both accounting and market information.

[4] See Heggestad (1979) for a recent survey evidence on the structure-conduct-performance model in banking.



The impact of deregulation can still be measured by the traditional chain reaction.

the long run. Research in the industrial-organization area usually is rich with implications for public policy.[5] However, from management's perspective, there also is a need for research that will identify how to prosper and survive in the more competitive environment of the 1980s.[6] By identifying *symptoms* of good performance and tracking those symptoms to their *causes,* managers of financial institutions will be better equipped to survive in a deregulated environment.[7]

[5]For example, a recent reexamination of the economies-of-scale issue in banking indicates that large unit banks may be the most vulnerable institutions in a world without geographic barriers. See Benston, Hanweck, and Humphrey (1980).

[6]For an example of this kind of research see Ford and Olson (1978). For a description of the characteristics of low performance banks, see Sinkey (1979).

Summary

The relaxation of interest-rate, geographic, and production-specialization restrictions, combined with competition from money-market funds, foreign banks, and nonfinancial corporations, is revolutionizing the financial-services industry. For an industry that has been programmed for change in a piecemeal and evolutionary way, these changes may come as a cultural shock. The ground rules are drastically different now, and it is imperative that regulators, bankers, and researchers adjust their expectations of what kind of safety and what kind of performance they should expect from depository institutions in this new and dynamic environment. The playing field is almost level now, but the rules and players are different. Moreover, it is difficult to tell the players even *with* a scorecard.[8] On balance, the opportunities and need for research have never been greater. ER

—Joseph F. Sinkey, Jr.

[7]I have stressed this approach in my forthcoming book **Commercial Bank Financial Management**, see Sinkey, (1982), Chapter 7.

[8]See Wriston (1981).

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