

DEREGULATION: THE CHALLENGE AHEAD FOR BANKING

By William M. Isaac\*

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Today I will talk about deregulation of the financial services industry and some of the steps commercial banks might consider to help them retain their preeminent position within that industry.

Deregulation means different things to different people. To many bankers, it means eliminating or substantially reducing the burdens imposed on them in recent years by a vast amount of social legislation. Unquestionably, a number of these laws and their attendant regulations -- most notably Truth-in-Lending -- can and should be greatly simplified, but the basic thrust of the legislation is not likely to be changed. To some, deregulation means relief from disclosure requirements under the securities laws. In my judgment, this is misdirected in that public disclosure is intended to facilitate marketplace discipline in lieu of government regulation. Again, the most that should be expected is simplification. Deregulation to others means less stringent enforcement with respect to unsound or abusive practices. Public confidence in the strength and integrity of our institutions is the cornerstone of our financial system. While we should avoid second-guessing management decisions, requiring excessive paperwork, and meddling in the credit markets, vigorous enforcement with respect to unsound or abusive banking practices is a

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permanent feature of the regulatory landscape. Still others believe that deregulation means less enthusiasm for anti-trust enforcement. In my opinion, this misses the point. A thriving market economy -- one comprised of many competitors and without undue concentrations of power -- is a prerequisite of economic freedom. Vigorous antitrust enforcement is an indispensable part of the equation.

To me, the term deregulation means elimination or reduction of the legal barriers to competition. The most conspicuous example of competitive deregulation in recent memory is the airline industry. However, deregulation of the financial services industry is distinguishable from airline deregulation in two important respects. First, airline deregulation has occurred comparatively swiftly, while deregulation in the financial services field has been more evolutionary in nature. Secondly, airline deregulation has been the result of planned government action, while deregulation in the financial field has largely occurred in response to market developments which frequently emerged despite government policy.

There are three basic government-imposed barriers to competition in the financial services industry: mandatory specialization, restraints on geographic expansion, and interest rate controls. I will briefly trace the origins of these barriers and their erosion over time. I will then suggest some actions for commercial bankers to consider if their institutions are to survive and prosper in the years ahead.

BARRIERS TO COMPETITION

Mandatory Specialization

Specialization by depository institutions, although currently mandated by law, originated in the marketplace. The first commercial bank chartered in the United States was founded in Philadelphia by Robert Morris in 1781. Other states quickly followed Pennsylvania's lead, and by 1794 eighteen commercial banks had been chartered. These banks furnished deposit and loan services to commercial and governmental customers.

In 1816 two mutual savings banks began business, one in Philadelphia and one in Boston. At the time, commercial banks felt small individual accounts were uneconomical, so mutuals were established by philanthropists to meet the savings needs of wage earners in the industrial cities of the northeast. Mutuals encouraged thrift by paying interest on savings, and it was hoped that these savings would help tide the workers over periods of unemployment. Despite the absence of charter restrictions, the early savings banks did not make loans; they invested their funds only in state and federal securities.

The first savings and loan association was organized in 1831 in Pennsylvania. This intermediary was needed to finance the purchase of homes by industrial workers who had neither the time nor the materials to build their own housing. At the time, commercial banks would not make

housing loans. The National Bank Act of 1864 codified this situation by prohibiting real estate loans by national banks. It was felt that long-term mortgages were not appropriate for commercial banks, which had relatively short-term deposits.

Twenty savings banks failed during the Panic of 1873, resulting in adoption by the New York State Legislature of the General Law of 1875, which became the model for all mutual savings bank state laws. The law prohibited personal loans and established limitations on mortgage loans for mutuals.

During the latter part of the 19th Century, commercial banks began to accept small savings deposits and evolve into full-service institutions. During this same period, mutuals began increasing their investment in mortgages, particularly during the 1890s when government debt became scarce.

The first credit union in the United States was formed in 1909 in New Hampshire. The credit union was a cross between the early savings banks, which encouraged thrift, and the early savings and loan associations, which encouraged self-help, but with the added element of a common bond among its members. The need for credit unions arose from the lack of legitimate consumer lenders due in part to unrealistically low state usury ceilings. Both savings and loan associations and savings banks were prohibited during this period from making personal loans, and commercial banks chose not to do so.

The Federal Reserve Act of 1913 modified the National Bank Act by permitting national banks to engage in limited real estate lending. This authority was expanded further in 1935. Two years earlier, in 1933, the Glass-Steagall and Act circumscribed the securities activities of commercial banks.

The rest is recent history and each person in this room is thoroughly acquainted with it. Commercial banks, savings banks, savings and loan associations, and credit unions have steadily expanded their activities and competition has increased among them on both sides of the balance sheet. The problems created for consumer and mortgage lending specialists by our nation's pattern of rising and volatile interest rates virtually assure that these specialists will seek additional flexibility. Thus, our nation's 14,700 commercial banks are likely to find themselves competing even more directly and more intensely with the 27,300 mutual savings banks, savings and loan associations, and credit unions.

While I have focused in this brief history on the development of four types of depository institutions, I should at least note the growing presence in U.S. markets of foreign banks and the increasing intermediation role being played by investment banking firms, credit card companies, the commercial paper market, insurance companies, finance companies, mortgage bankers, large retailers, and money market funds.

There is a clear lesson in this history both for the industry and for government. The marketplace is relentless in its quest to satisfy demands for new and improved products and services. If commercial banks had identified and served the legitimate demands for consumer savings services, mortgage loans, and consumer loans, there would have been substantially less need for the nearly 28,000 specialized depository institutions that ultimately developed. If depository institutions were not constrained by Regulation Q, money market funds would be of little note today.

Surely the Eurodollar market would be of less significance were it not for the growing cost of sterile reserves as interest rates continue their secular climb. The examples are many. We ignore the marketplace at our peril.

#### Restraints on Geographic Expansion

Let me turn to the restraints on geographic expansion. Prior to the Civil War, there did not appear to be any strong feelings either for or against branch banking in the United States. Despite Alexander Hamilton's reservations about managerial capacity, The First Bank of the United States, organized in 1791, established eight branches in the nation's leading cities. The Second National Bank of the United States, organized in 1816, established twenty-six branches. In our early banking history, most state banks were established under special charters issued individually by state legislatures, so branch banking authority frequently

varied from bank to bank rather than from state to state. Four of the most successful banks of their day were the State Banks of Indiana, Iowa, Missouri, and Ohio, which had statewide branching privileges.

The National Bank Act of 1864 was interpreted as prohibiting branching by national banks. This Act also imposed a stiff tax on the issuance of state bank notes and nearly destroyed the state banking system. Thus, branching almost disappeared after the passage of the Act.

Development of the demand deposit account, which largely displaced bank notes, led to the resurgence of the state banking system and, with it, branching. By 1924, 18 states permitted some form of branching, 18 states prohibited it, and 12 had no law on the subject. The Comptroller of the Currency urged Congress to equalize the competition between state and national banks, touching off a controversy which led to adoption of the McFadden Act in 1927. This Act extended limited branching powers to national banks, but state banks continued to have competitive advantages in branching. By 1932, 23 states permitted branching, 18 prohibited it, and 7 had no law on branching. The Banking Act of 1933 permitted national banks to branch wherever state law permitted state banks to branch. The third draft of this bill contained a measure that would have permitted a national bank to branch anywhere within its state and into a neighboring state within 50 miles of the

production and representative offices, Edge Act corporations,



home office, but this provision was filibustered out of the bill. By 1936, 34 states permitted some form of branching, 9 prohibited it, and 5 had no law on the subject.

Two early devices were developed to circumvent branch banking limitations: chain banking groups and multibank holding companies. Bank holding companies flourished during the 1920s and again in the period following World War II. Legislation was enacted during the 1930s to control certain practices by chain banking groups and to require some bank holding companies to register with the Federal Reserve. The Bank Holding Company Act of 1956 expanded the registration requirements, limited the nonbanking activities of multibank holding companies, and restricted their interstate expansion. The Act was amended in 1970 to apply to one-bank holding companies and to liberalize the permissible nonbanking activities.

Banks have been motivated to expand geographically in part simply to harvest additional profits. But another goal, importantly served by geographic expansion and the accompanying growth in size, has been to develop a stronger, more diversified firm with more extensive management resources and greater access to financial markets.

The general direction in which the industry is headed with respect to geographic restraints has been unmistakable for years. Today only a handful of states do not permit statewide banking by banks or bank holding companies. Loan production and representative offices, Edge Act corporations,

foreign branches, and so-called nonbanking affiliates have extended the reach of major banks far beyond their head offices. Advances in transportation, communications, and computer technology are rendering less and less significant the remaining legal obstacles to geographic expansion.

It is difficult to predict how fast this process of geographic diversification will proceed or the precise form it will take. But given the inexorable press of market forces against the remaining barriers, it most assuredly will continue.

#### Interest Rate Controls

The phase out of interest rate controls is occurring at a more rapid pace than is the liberalization of geographic restraints. Although some commercial banks paid interest on deposits around the turn of the 19th Century, the practice did not become common until the 1850s. In 1851 the Massachusetts Banking Commissioner complained that the payment of interest on deposits was draining funds from certain localities and posing potential liquidity problems for the banks buying the funds. In 1854 Connecticut adopted an interest rate ceiling of 4 percent, which remained in effect for one year. The concern spread to other states and was heightened by the Panic of 1857, which some argued was attributable in part to the movement of funds from country to city banks in pursuit of higher rates of return. Some 40 New York City banks signed an agreement in the late 1850s to discontinue the payment of interest on deposits.

In 1869 the Secretary of the Treasury and the Comptroller of the Currency charged that the payment of interest on deposits was causing money to be funneled into risky ventures and recommended that the practice be prohibited. Legislative initiatives in the Congress to prohibit interest on deposits failed, and the issue seemed to lose its momentum until the early 1900s when the Comptroller of the Currency and the Federal Reserve became concerned about excessive rate competition. Although federal legislative efforts were not successful, a number of clearing houses, with encouragement from federal bank regulators, entered into private agreements to control rate competition, and some states adopted rate ceilings.

Finally, in 1933 in the midst of the collapse of our banking system, Congress passed legislation prohibiting the payment of interest on demand deposits and limiting other deposit interest rates at commercial banks. Although little evidence was introduced that excessive rate competition had led to the banking crisis, the final bill was adopted in less than a month without debate.

Interest rate controls were not at issue during the first 20 years or so of their existence because market rates were generally below the controlled rates. However, on a number of occasions since 1957 market rates have risen above Regulation Q ceilings, causing increasingly severe deposit outflows and requiring that the ceiling rates be adjusted upward.

As the rates paid by banks rose during the 1960s, thrifts found it difficult to compete for deposits. Congress reacted in 1966 by extending deposit rate ceilings to thrifts for a one-year period. Congress made clear its intent to encourage flows to the mortgage market, and the regulators implemented congressional intent by giving thrifts the interest rate differential. The rate structure established in 1966 gave savings and loan associations a three-quarter point advantage and savings banks a full percentage point advantage on savings deposits. The statute has been regularly renewed, although the rate differential has been reduced over time.

It has been persuasively argued that Regulation Q ought to be phased out because it:

- (1) leads to disintermediation, particularly with respect to smaller banks and thrifts;
- (2) results in a misallocation of our financial resources;
- (3) subsidizes borrowers at the expense of savers; and
- (4) retards competition and protects marginal, inefficient competitors.

There is little doubt in my mind that Regulation Q will be eliminated or fully indexed within the next decade. While this will raise a number of difficult public policy issues which must be addressed, there does not appear to be any realistic alternative. The marketplace is simply overwhelming the controls. Just as the refusal by commercial banks to pay interest on small accounts in the early 19th

Century led to the establishment of mutual savings banks, interest rate controls have led to the creation of devices such as money market funds which are drawing funds from banks and thrifts alike.

#### MEETING THE CHALLENGE

If, indeed, the financial services industry is being deregulated, banking is certain to become a more complex endeavor, less forgiving of mistakes and inefficiencies. It will become a more challenging business with abundant rewards for success and greater penalties for failure. Management skill and good business sense will be at a premium.

I would like to suggest a few steps that financial institutions might consider to prepare themselves to compete in the world of tomorrow. Most of you have already made considerable progress along these lines, but I would encourage you to redouble your efforts.

1. Define Your Business. I believe that one of the most significant responsibilities of the board of directors and top management of each bank is to define the business of the institution -- its mission, its purpose, its goals. In defining your business it is important to look not only at your current markets and products, but also at how they will likely evolve in the years ahead.

The process of defining your bank's business requires implementation of suitable programs for strategic and long-range planning. Key existing and potential markets must be

identified, and strategies and products for penetrating those markets must be developed. Should you concentrate on a segment of the market or offer a full range of services? Should you expand your geographic market? If so, should it be accomplished by de novo growth or by acquisition? Are your offices suitable and well located? Do you have too many branches or too few? Do you have the requisite technological resources? These are the kinds of questions that must be addressed.

2. Evaluate and Develop Managerial Resources. A second principal responsibility is to evaluate and develop your bank's managerial resources. Does your bank have the cadre of professional managers and technical experts necessary to meet the long-range goals you have established? If not, what steps do you need to take to attract them? Does your bank have a plan for management succession and a strong program for management training? Has your bank established a realistic compensation program, and does the program contain well-designed incentives for senior management?

One of your bank's most valuable assets should be its board of directors. A good board has a large proportion of entrepreneurs -- people who have experience in managing successful businesses, preferably public companies where possible. An effective board is independent and challenges management's assumptions and conclusions. The best friend -- and the best protection -- that management can have is a

strong and interested board that helps management formulate policies and goals and participates in strategic decisions. Such a board helps management avoid serious mistakes and is more likely to share responsibility for the mistakes that will inevitably be made.

3. Improve Accounting, Control, Information, and Disclosure Systems. As your bank grows in size and complexity, it will become increasingly important to improve its accounting system; its audit, credit review, and other control systems; its management information system; and its financial disclosure system. The accounting system should inform management what a service costs and how it must be priced to earn a profit. Good credit review and audit systems become essential as the bank grows and begins to lose intimacy with its customers and employees. The management information system should provide a means for top management and the board to evaluate key personnel and lines of business, to monitor exposures and asset and liability maturities, and to control interest-rate sensitivity. Development of an accurate and complete financial disclosure system becomes necessary as the bank turns to money and capital markets to sustain its growth.

4. Control Costs. In an intensely competitive environment, the ability to identify and control costs could be the difference between success and failure. Control of personnel and other operating expenses is becoming one of management's most important and most difficult assignments.

5. Foster Better Community Relations. The cloak that shrouded banking and bank regulation for decades has been largely removed over the past 10 years. Bankers and bank supervisors, alike, are being confronted with many new challenges from various sectors of society. An enlightened bank will anticipate these challenges and make every reasonable effort to meet them. You owe it to yourself and your institution to properly identify and meet the needs of your community.

6. Get Involved Politically. My final suggestion is that you get involved in the political process. It is clear that over the next couple of decades a number of critically important political decisions will be made concerning our financial system. You can have an effect on the outcome if you make the effort to participate in the political process. I would only ask that when you review these important issues and formulate your positions, look beyond the short-range effects on your bank, be willing to compromise, and pay due regard to the long-range interests of our nation. In the final analysis, that will benefit us all.

#### CONCLUSION

Let me leave you today with a final thought. In the years ahead, we will not have a choice between change or no change. Change will occur, and it will be substantial. The only choice will be between controlled or uncontrolled change. To paraphrase Toffler, will we be masters or victims



of the process of change -- will we be the masters of our own destiny or will we succumb to "future shock"? For the banking industry, that choice is largely in your hands.

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