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THE BANK REGULATORY CLIMATE OF THE 1980s: A FORECAST

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An address by

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It gives me great pleasure to join you today as you focus on the major issues confronting the banking industry in the 1980s. My assignment is to forecast probable developments in the bank regulatory climate during the decade ahead with particular emphasis on deregulation, capital standards, and merger policies.

I embark on this effort with more than a small amount of trepidation. Forecasting is, at best, an imprecise science. Moreover, it is my experience that when a speaker predicts future events the audience often assumes that the speaker advocates the changes that are forecast. I view my responsibility differently. I believe that I must attempt in good faith to present things as they are, or are likely to be, not how I might wish them to be.

I. THE ROLE OF GOVERNMENT

When looking to the future of banking, many people make the mistake of exaggerating the role of government in shaping events. The truth is that developments in the private sector, not the government, provide most of the impetus for change in banking. These forces, in turn, result in changes in bank regulation. In part, this is simply a reflection of the fact that in a free society there are constraints on government action.

First, government must be responsive to the will of society. Most people -- bankers and bank regulators included -- are resistant to change. This resistance is natural. Change -- particularly if it is unpredictable or

too rapid -- is threatening; it frequently involves a realignment of power, wealth, or position. In the absence of a political consensus favoring action, government is immobilized.

Secondly, we must recognize that one of government's most vital functions is to nurture the political and economic stability necessary to induce the investment required for continuing growth. Abrupt or frequent changes in important government policies tend to create uncertainty, erode confidence, and discourage investment. Thus, government normally moves slowly, reacting to circumstances and events in the private sector rather than leading them.

That is as it generally should be, because the third point is that in our society we have long believed in the efficiency and wisdom of the marketplace. We reject the very notion of a planned society. While we have come to expect a degree of government intervention -- for example, to promote competition, to ensure a reasonable degree of economic stability, to protect the environment, to create a climate of equal opportunity, or to assist those in need -- our instincts tell us that government interference in the marketplace should be limited. Those who propose intervention must prove to us that the intervention is necessary.

The key to the future, then, lies not with the government but with the marketplace. If we can identify significant trends in the private sector, our task of predicting changes in the regulatory climate will be easier.

II. THE MARKETPLACE

There are two aspects of the marketplace that I want to touch on today: technological advances and economic trends. After I review developments in these areas I will address the issues of deregulation, capital standards, and merger policies.

A. Technology. Technological advances in three areas -- telecommunications, transportation, and computers -- are having a profound effect on the banking landscape. From the mid-1800s through the 1960s, government policy, in response to a variety of political and economic forces, erected and maintained three legal barriers to competition among depository institutions -- geographic restraints, interest rate controls, and mandatory product specialization by depository institutions.

These competitive barriers were effective through the early part of this century because the pressures against such restraints were relatively slight. Transportation systems were poor; neither bankers nor their customers could travel great distances to transact business. Communication systems were primitive, making it difficult for bankers to manage distant operations and rendering bank customers comparatively ill-informed with respect to the services and prices offered in other locales. The absence of computer technology further restricted the practical scope of banking, both geographically and in terms of size and type of account activity.

The automobile, the airplane, radio, the telephone, television, and the computer have clearly changed these conditions and have resulted in increased competition in financial markets. A bank in New Orleans can be in continuous contact with its branch offices in London, Rome, or Tokyo. Calling officers can travel to Los Angeles more easily today than they could have to Shreveport a century ago. Bank customers are more sophisticated, are better informed about the services and prices offered by competing intermediaries, and are willing and able to reach out greater distances to conduct their business. Computers have made it easier to manage geographically diverse operations and to process profitably an enormous volume of transactions.

Technology has enabled banks and other financial intermediaries throughout the world to reach out farther and farther for business. Modest-sized firms located in formerly isolated communities are being solicited today by banks and other intermediaries from around the globe.

Banks have not been able to tap one major remaining market: distant, retail deposit customers. These customers are highly convenience oriented and no good way has yet been found to attract their business in volume without nearby branch offices.

However, even this last remaining hurdle is being surmounted. Money-market funds, sponsored by brokerage houses, insurance companies, and others, are making substantial inroads at the upper end of the market. They now

hold approximately $80 billion in customer funds, much of which is redeposited in money-center banks in the U.S. and abroad. Bank holding companies and their nonbank affiliates are issuing deposit-like instruments which are attracting rate-conscious savers. A subsidiary of one major bank holding company is paying 5.5% interest on credit balances maintained by out-of-state holders of its new credit card, and is studying the feasibility of offering this service to retail customers throughout the world. Moreover, several banks are beginning to experiment with cable television and computer systems which may make it possible for retail customers to carry out ordinary banking transactions in their homes.

It seems clear that technological change has reduced the effectiveness of the protective barriers constructed around our nation's financial intermediaries. It seems a good bet that this trend will not be reversed. Despite, or perhaps spurred by, current energy shortages and other problems, advances will likely continue in transportation, communications, and computer technology, and new vistas will be opened to financial intermediaries.

B. Economic Trends. There are several circumstances in the economic arena which have contributed to the breaking down of regulatory barriers and have implications for banking in the decade to come. The economic climate has become harsher and less predictable in recent years, making the banking business more complex. Over the past 15 years

or so we have struggled with inflation, which has resulted in volatile and extraordinarily high interest rates followed by recession and high unemployment. Managers of financial institutions can make serious mistakes in this kind of environment, and some have done so.

Financial intermediaries have been among the hardest hit by the effects of inflation. Volatile interest rates have made it difficult to price loans and manage portfolios. Soaring market rates of interest have depreciated the value of financial assets, have exposed financial institutions to periods of disintermediation, and have caused a realignment of liabilities away from low-cost demand and passbook accounts to instruments with substantially higher yields, putting pressure on profit margins. Net loan losses at commercial banks have averaged .40% of loans over the past decade compared to less than .15% during the 1960s. The inflation of balance sheets, coupled with a decline in profitability at many banks and thrifts, has resulted in a significant deterioration in capital ratios, particularly among the largest firms.

Clearly, these trends cannot continue indefinitely. Either the means will have to be developed to permit financial institutions and others in our society to cope with high rates of inflation or inflation must be eradicated. I prefer to believe that we will confront and solve our most pressing economic problem rather than simply learn to live with it.

Apart from conditions in our own economy, developments are taking place in the world economy which also have implications for banking and bank regulation. In recent decades, we have witnessed the internationalization of the world's business community, and foreign trade has clearly become more important to the U.S. economy. The combination of imports and exports represented 22% of our GNP last year, compared to only 12% in 1947.

The U.S. emerged from World War II with by far the strongest economy in the world. However, since then resource-rich, previously undeveloped countries have blossomed. The war-torn economies of Europe and Japan have been rebuilt and now boast some of the most efficient production processes. The U.S., which accounted for half of the world's exports in 1947, contributed only 13% in 1979.

Increased economic interdependence and the growth of other nations' economies vis-a-vis the U.S. are clearly affecting our financial system. Our major banks have expanded throughout the world to serve their customers and seek out new relationships. At year-end 1979, 22% of the assets of U.S. banks were held in foreign countries, compared to 15% in 1974. At the same time, major banks from other nations have been making inroads in the U.S. Foreign banks, through branches, subsidiaries, agencies, and investment companies, controlled 12% of U.S. domestic banking assets at year-end 1979, compared to only 5% in 1974.

Barring major political upheavals or war, these world-wide economic trends are likely to continue. U.S. businesses, including banks, should anticipate even greater competition, at home and abroad, from firms of other nations. This will create many challenges for bank supervisors and will place further pressures on the structure of the financial services industry in the U.S.

III. THE FUTURE REGULATORY CLIMATE

With these technological developments and economic trends as a backdrop, it is time to speculate about the future regulatory environment. I will consider three interrelated topics -- deregulation, capital standards, and merger policies -- in that order.

A. Deregulation. There are at least two aspects to the term "deregulation" as it pertains to banking. To many bankers the term means "regulatory simplification", or a significant reduction in the cost and burden of government regulation, particularly in the consumer protection area. To others it means "competitive deregulation", or liberalization of the controls on competition among financial intermediaries. I will consider each aspect of deregulation separately, beginning with regulatory simplification.

Without question a number of laws and regulations affecting banks can and should be greatly simplified. Particular emphasis should be placed on reducing the impact of these measures on smaller banks. Small banks frequently do not have access, on their staffs or in their communities,

to the experts necessary to cope with such laws, and they have a comparatively small number of transactions over which to spread the cost of compliance.

The federal banking agencies are keenly aware of the necessity to reduce the adverse effects of regulations and have taken a number of steps in that direction over the past two years. The FDIC established a task force to review each of our regulations to determine whether it was still needed and, if so, whether it could be simplified. Last year we achieved modest success by eliminating six regulations, substantially reducing a seventh, and simplifying several others.

We established procedures to ensure continuing evaluation of the regulatory process in the future. We adopted a policy statement which requires that the FDIC's board of directors be informed of each proposed regulation in its early, developmental stage and requires that a cost/benefit analysis be done whenever feasible. The continuing need for each regulation must be reviewed every five years.

Our policy statement requires that we specifically assess the impact of each regulation on small banks. If we find that the impact is likely to be significant, we must exempt the small banks, or develop a less onerous version of the regulation for them, whenever it is legally permissible and appropriate to do so.

Moreover, we are currently conducting a series of seminars around the nation designed to assist banks in meeting their responsibilities under the various consumer and civil rights laws.

We have also focused attention on our examination and applications procedures. We are firmly committed to lessening the burden of dual regulation on state banks and reducing the time required to process applications.

A divided examination program has been instituted in eight states, and others will be added soon. Under this program, instead of the state authority and the FDIC both examining a small, nonproblem bank each year, the state examines one year and the FDIC the next. The results of the examinations are, of course, shared. The total savings to the states and the FDIC will amount to millions of dollars annually, and the burden on banks will be lessened.

We have taken a number of steps to streamline the applications process. About six months ago our board adopted guidelines, which are available at our regional offices, to assist banks in filing applications with the FDIC. We have delegated substantial authority to our regional offices to approve "clean" applications and are contemplating further delegations. We have substantially simplified our application forms, and are working with a number of states to design common forms. We are encouraging concurrent filing of applications with the states and the

FDIC so they may be investigated, processed, and disposed of simultaneously. Finally, in evaluating applications, we are focusing more attention on the fundamentals of a bank, such as its capital adequacy and managerial resources, rather than second-guessing management decisions or substituting our judgment for the market's.

Clearly there is much that can be done to promote regulatory efficiency and lighten the burden of regulation on banks. The FDIC and the other banking agencies have already made substantial progress along these lines and intend to do more. However, I must caution that there are practical and legal limits on our ability to achieve a substantial reduction in the regulatory burden in the absence of specific Congressional direction.

Competitive deregulation, which is the second aspect of deregulation, involves relaxing the three legal limits on competition among depository institutions: geographic restraints, interest rate controls, and mandatory product specialization.

Geographic restraints are coming under pressure due to a number of factors, the most significant being technological advancement. It is becoming increasingly difficult to insulate banks against encroachment by firms located outside their market areas. Unregulated or less regulated businesses such as money-market funds, retailers, investment banking firms, credit unions, and savings and loan associations continue to make inroads. Large money-center banks

are discovering many ways to circumvent the barriers, either directly or through their nonbank affiliates.

While one can be reasonably confident in predicting that marketplace forces will ultimately mandate a liberalization of the laws restricting geographic expansion by banks, it is difficult to predict the speed with which this will occur or the exact form it will take. This uncertainty is due to the current inability to arrive at a political consensus.

I believe that many banks which currently favor these restrictions will eventually decide that the restraints are counterproductive. They will conclude that the barriers are fairly effective in restricting the activities of smaller firms but do little to contain larger, more aggressive banks or less-regulated nonbank intermediaries.

I hope, but am not confident, that the states will take the lead in any necessary reforms. Those states which do not have some form of statewide banking must consider whether their laws are retarding the development of strong, locally oriented institutions capable of competing in the evolving financial system. The time has come for all states to give serious consideration to compacts with neighboring states to permit some form of regional reciprocal banking. Compacts of this sort raise some legal issues, which may have to be resolved through federal enabling legislation, but these issues should not stand in the way of a serious

debate of the merits underlying such arrangements. Any liberalization should be phased in over an adjustment period and designed in a way to permit smaller firms to adapt and maintain their competitive effectiveness.

The picture is somewhat clearer with respect to the future of interest rate controls and mandatory specialization, which have both been addressed by recent federal legislation. Advanced technology makes it feasible for increasingly sophisticated customers of depository institutions to turn elsewhere for higher yields on their savings. High and volatile interest rates resulting from inflation provide these customers a strong incentive to seek alternative investment vehicles. Depository institutions are confronted with declining market shares and periodic bouts with severe disintermediation. The majority of institutions recognize they must be given the freedom to pay higher rates for deposits if they are to remain competitive. Moreover, many recognize that if inflation is to be controlled, savers must be given a fair return and must not be asked to continue subsidizing borrowers.

These marketplace realities made it possible, earlier this year, to forge a political consensus which resulted in enactment of the Depository Institutions Deregulation and Monetary Control Act. The Act established a Deregulation Committee with the mandate to phase out deposit interest rate ceilings over a six-year period. Without interest rate

ceilings, there obviously can be no interest rate differential in favor of thrifts. To offset the eventual loss of this advantage and to better prepare these institutions for the future, thrifts were given additional flexibility on both sides of the balance sheet. Thus, while no one can be sure precisely what the future holds, interest rate controls and mandatory specialization appear to be on the way out.

If I am correct in my belief that the financial services industry is entering a period of substantial competitive deregulation, long-standing concerns regarding capital standards and merger policies will intensify in the years ahead. Let me turn to these topics.

B. Capital Standards. Bank capital ratios have declined fairly steadily for more than a century. This trend has been exacerbated in more recent years by the effects of inflation. If inflation is brought under control it will be easier to stem this decline in ratios, which clearly cannot be permitted to continue indefinitely without potentially serious repercussions.

Be that as it may, even the status quo with respect to capital ratios is of serious concern to many from the standpoint of competitive equality, a concern which can only become greater in a deregulated, more competitive environment. At issue is the disparity in capital ratios among banks of different sizes. At year-end 1979, banks with less

than $100 million in assets had equity equal to 8.2% of assets. This percentage was 6.4% for banks with between $100 million and $5 billion in assets and only 4.0% for banks with over $5 billion in assets.

This disparity has arisen for a variety of reasons. As we continue our evolution to a less-restricted competitive environment, many bankers are finding the disparity more and more objectionable. Smaller firms are finding themselves increasingly disadvantaged because they must temper their rates of growth, achieve higher profit margins, or both in order to maintain higher capital ratios.

Some argue that the disparity can be substantially eliminated over a reasonable transition period. Others contend this approach would not be practical, and argue that a better solution would be to charge higher deposit insurance premiums for firms with lower capital ratios. Whatever the proposed solution, this issue cries out for, and will receive, attention as the barriers to competition among banks are further eroded.

C. Merger Policies. Merger policies will also be the subject of much debate in the years ahead as we move into a less-regulated environment.

One issue that will likely grow in importance is the degree to which banks, particularly the smaller ones, will be permitted to join in cooperative ventures to enhance their market positions and achieve operating efficiencies.

The cooperative programs might relate to a number of areas including data processing, EFT, trust services, portfolio management, long-range planning, and marketing.

Another issue will be whether more weight should be given, in our competitive effects analysis, to the market shares held by intermediaries other than commercial banks, particularly savings and loan associations and mutual savings banks. This question will gain importance as thrifts acquire additional commercial banking powers, as they have done under the Depository Institutions Deregulation and Monetary Control Act.

Our society has long been concerned about undue concentrations of economic power. I believe this concern will intensify with respect to the financial sector in the years ahead. The debate will likely center on whether more guidance can and should be provided with respect to the structure of the financial services industry -- particularly within broader geographic areas such as states, regions, or the nation. In considering this issue, four factors will be particularly relevant to policy makers: a) past patterns of sizeable acquisitions by large firms in banking and other industries, b) the widely divergent merger policies applied over time by the federal agencies, depending on the philosophies of the individuals who hold decision-making authority, c) the emasculation of the potential competition doctrine by some federal district courts, and d) the possibility that liberalization of the three legal barriers to competition

among financial intermediaries may increase the pressure for consolidations.

IV. CONCLUSION

Public policy with respect to financial institutions has for years been directed at promoting economic growth, fostering sound and efficient depository institutions, preventing undue concentrations of power, and providing for an adequate supply of credit to groups such as farmers, consumers, small businesses, and home buyers. Although we have witnessed, and will continue to experience, periodic shifts in emphasis, I believe these basic policy objectives will remain unchanged for some time to come.

What is changing is that developments in the marketplace are rendering ineffective or even counterproductive some of the tools utilized by government to achieve these objectives. Our challenge is to design new, politically acceptable tools to enable us to achieve our basic aims within the context of current marketplace realities. Such tools should entail a minimum of government intervention and cost to society.

This task is complex, and it seems threatening to many. However, I see no reasonable alternative to accepting the challenge and moving ahead. To sit by idly -- to ignore modern-day realities -- poses the greatest threat to us all.

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