DEREGULATION–IS IT HAPPENING IN BANKING?

Harry Guenther

WITH THE POSSIBLE exception of oil, probably no industry is viewed by liberal politicians—and much of the public—with a more jaundiced eye than banking. And, somewhat ironically, few if any industries are regulated more closely and none has been regulated for so long.[1] Nevertheless, because of the unique role commercial banks play among financial institutions and because of the crucial place they have come to occupy in nearly all our lives through their credit-granting function, banking is a favorite target of those who believe government makes better decisions than the market or who simply dislike the harshness of market decisions. Therefore, while the politics of trucking and airline deregulation may be relatively easy to understand, it has been somewhat surprising to hear talk of bank deregulation.

And not merely talk. Earlier this year Congress passed the Financial Institutions Deregulation and Monetary Control Act of 1980. That act provides, among other things, for the phased removal of ceilings on deposit interest rates, ceilings that many thought were essential to the well-being of the housing industry. The legislation was enacted in the midst of—and some say because of—the near panic that accompanied record-breaking interest rates and a severe slump in housing activity in the first months of 1980.

Despite this major step in the direction of deregulating competition in banking, there exists a contrary trend—to regulate behavior or performance more tightly in an effort to achieve social goals that have little if anything to do with bank safety. Indeed, the danger is that banking will become so hampered by additional

Harry Guenther is associate professor of finance in the School of Business Administration at Georgetown University.

[1] The earliest congressional endeavors in bank regulation were statutes creating the First Bank of the United States (1791) and the Second Bank of the United States (1816). Years later (1864), a regulatory framework was created by the National Bank Act, which established the Office of the Comptroller of the Currency, the primary regulator of national banks to this day.

performance restraints that the potential benefits to consumers of lessened regulation of competition will be offset by the added costs of increased social regulation. The further danger is that these added costs will hit the smaller banks the hardest, eroding their ability to find a niche in the new, more competitive environment. If these dangers become reality, they might produce a backlash of new competitive and performance restraints designed to preserve certain elements of the status quo without regard to the net cost for the banking public.

In view of these contradictory trends, it is worth asking whether banking is in fact experiencing a net reduction in regulation, and if so, in what ways and with what probable results. But, first, a brief description of banking regulation and of recent proposals for change.

The Regulatory Framework

Commercial bank regulation has three objectives: (1) to prevent undue concentration of power, (2) to provide for safety and soundness, and (3) to ensure performance in meeting society's goals. These objectives are neither mutually exclusive nor entirely consistent. Regulation of competitive structure to guard against concentration takes the form of controls over entry (both charters and branches), mergers, acquisitions, and exit. In addition, commercial banks are subject to the antitrust statutes (and the scrutiny of the Justice Department). While the objective of these restraints is to ensure competition, they often have the opposite effect. Regulation of safety and soundness is carried out through numerous statutes and regulations that restrict the activities in which banks may engage, the degree of risk they can undertake, and the capital they must maintain, and by periodic agency examinations of every bank's books and records.[2] Regulation of performance to achieve social goals is also carried out through statutes and regulations and by periodic examination. It focuses on the disclosure of information to customers, on the equitable treatment of customers, and on the distribution and pricing of a bank's services in its market area or community.

This multiplicity of regulation is rendered more complicated by virtue of the fact that banking is subject to three federal bank regulatory agencies and to state regulation as well. A national bank is chartered and supervised by the Office of the Comptroller of the Currency (OCC) but, because such a bank is automatically a member of the Federal Reserve System (FRS) and insured by the Federal Deposit Insurance Corporation (FDIC), it also is subject to the regulations of those agencies. In addition, it is subject to certain of the banking laws in the state in which it is domiciled, including laws specifying the interest rates it can charge and the extent, if at all, to which it can "branch" (expand by setting up branch offices). A state bank is chartered and supervised by the appropriate regulatory agency in the state in which it is domiciled. It also is subject to FRS regulations if it is a member bank—and, even if not a member, it may be subject to recent FRS rules governing reserves. If it is insured, and nearly all banks are, it is also subject to the regulations of the FDIC.

It is this somewhat complicated regulatory framework that first gave rise to serious talk of the need for fundamental reform. Critics have long contended that the present structure results in competition in laxity (as agencies seek to retain their industry constituencies) and in a tendency for tardy action (because each agency assumes that another has problem situations fully under control).[3] Thus, beginning with the Hoover Commission reports of 1947–49, numerous proposals have been offered, all of them calling for some simplification of the regulatory framework to reduce duplication or overlap. As readily can be imagined, the choice of the agency in which regulatory authority was to be concentrated often reflected the agency or institution from which the recommendation came. The same was true of the role the states would play after the recommended restructuring.

The Expectation: Recent Proposals for Reform

The calls for deregulation or regulatory reform have come from diverse quarters—incumbent administrations, the House of Representa-

[2] Control of entry, of course, also contributes to safety by limiting competition and thereby raising profits.

[3] It should be noted that the framework has its adherents who cite among its virtues the system's flexibility.

tives, the Senate, and the industry itself. Most of the proposals address one of three sets of issues—regulatory structure, rate control, and geographic restraints.

Regulatory structure. All proposals have recommended some centralization of federal supervision and regulation within a single, possibly new, agency or commission. This body would take over the supervisory and regulatory functions of the FRS and, in some versions, of the FDIC as well, with the OCC operating as part of the reorganized or new agency. The regulation of state-chartered banks would also come under this new agency, with the degree of independent autonomy for state regulation varying by proposal from a considerable amount to none.

Rate control. Ever since the Banking Acts of 1933 and 1935, there have been restrictions on the prices commercial banks can pay for their raw material, deposits. For checking accounts the ceiling was zero, and for time and savings deposits it varied according to maturity and deposit size. Originally a device to help banks control expenses and to prevent the "unsound" competition that supposedly helped cause the collapse of the banking system in the early thirties, deposit-rate ceilings later were viewed as a means of aiding home ownership through sheltering the primary mortgage lender, the thrift institution.[4] Still later, when market interest rates rose above deposit-rate ceilings and resulted in periods of sharp disintermediation (outflow of funds from depository institutions) and housing slumps (despite the controls), the ceilings were viewed as a means of restricting competition between commercial banks and thrifts.

Rate control was attacked on the grounds that it was inequitable to commercial banks. This inequity was alleged to arise from the ¼ point advantage in the ceiling that savings banks and savings and loan associations enjoyed (credit unions enjoyed an even greater rate advantage) and from the drastic growth in nonregulated competition, particularly from money market funds and deposit-like services of brokerage firms (such as Merrill Lynch's Cash Management Account).

[4] Thrift institutions include mutual savings banks, savings and loan associations, and credit unions. The first two are major factors in the origination of residential mortgage loans.

The President's Commission on Financial Structure and Regulation (the Hunt Commission) recommended in 1971 that the power to set rate ceilings be abolished and that standby authority to set such ceilings be eliminated after ten years. Bills along those lines were introduced in the Congress in 1973 and 1975. In 1975, the Financial Institutions and the Nation's Economy (FINE) study, prepared under the auspices of the House Banking Committee, recommended that such controls be phased out over a five-year period; and similar proposals came from the banking industry and the Congress.

Geographic restraints. A third major thrust of proposals for regulatory change has been to relax the geographic restraints on competition in the banking system that date back to the McFadden Act of 1927 and the Banking Act of 1933. These restraints, which generally go unnoticed by the banking public and which are unique among U.S. industries, give each state the power to determine the extent to which banks, state or national, can branch within that state. State boundaries are the ultimate limit, with interstate branching prohibited even within metropolitan areas that span state boundaries. The so-called Douglas Amendment to the federal Bank Holding Company Act similarly prohibits interstate acquisitions of banks. It is these geographic restraints that account for the existence of the extremely large number of commercial banks in this country. Whereas most other developed countries have only a handful of commercial banks, we have over 14,000. In addition, because of state primacy in these matters, we also have major differences from state to state in terms of geographic flexibility. Some states, like California, permit statewide branching and multibank holding companies, while other states, like Illinois, prohibit both.

These geographic restraints are under attack for a number of reasons:

- They are anticompetitive, serving to shelter local banking monopolies and entrenched oligopolies to the detriment of the public;
- They are anachronistic, failing to take into account modern technology and the fact that many banking services can now be performed by remote electronic means, by telephone, and by mail;

- They are inequitable, limiting the ability of commercial banks to compete with the deposit and nondeposit institutions that face fewer geographic restraints, or none at all, and that are broadening their powers and appealing aggressively to the same customers; and
- To the extent there is reason to be concerned with concentration of economic power, there are other less anticompetitive methods of dealing with the problem.

The 1971 Hunt Commission report urged the states to be "progressive in changing their laws" on interstate branching and metropolitan area banking. And the FINE study favored branching in its "discussion principles":

> Interstate branching of all federally insured depository institutions would be allowed if branching did not conflict with state laws. In those states where there is a conflict, out-of-state federally chartered institutions would be allowed to branch in all Standard Metropolitan Statistical Areas . . . with population of two million persons or above.

Later, on October 28, 1977, the National Commission on Electronic Fund Transfers recommended that geographic restraints on electronic banking facilities be relaxed, and Senator Thomas McIntyre (Democrat, New Hampshire) introduced a bill to implement the plan. That bill provided for the exemption of electronic funds transfer (EFT) systems and their components from inclusion in the federal definition of a branch and permitted their installation by a national bank anywhere in the bank's natural market area after January 1, 1980.

Finally, in the International Banking Act of 1978 (which equalized the regulatory burden on foreign and U.S. domestic banks), Congress called on the Carter administration to examine McFadden Act restraints on banking and to recommend changes that would be important to the maintenance of the competitive position of U.S. banks. That study, initially due in September 1979, is expected to be released in late 1980. It is widely anticipated that it will call for the relaxation or elimination of geographic restraints on EFT units and for some relaxation of geographic limits on brick-and-mortar units, probably in the form of interstate holding-company acquisition of banks rather than interstate branching.

The Reality: Enactment of Reform

The broad spectrum from which proposals for reform have come would seem to have provided a solid base for significant action. Has this in fact occurred? The answer is both yes and no—plus a large element of what might be called "promises, promises."

The Good News. Judging by its title, the Financial Institutions Deregulation and Monetary Control Act of 1980 certainly sounds promising. And for a good many observers, including even the deregulation buffs, the actual deregulation it accomplished has come as a bit of a surprise. The most significant procompetitive change was the provision for the "orderly phase-out and the ultimate elimination of the limitations on the maximum rates of interest and dividends which may be paid on deposits and accounts as rapidly as economic conditions warrant" over a period of six years. Considering the extent to which thrift institutions and commercial banks, especially the smaller ones, have been partially sheltered by these ceilings—and considering also the apprehension of the thrift and housing industries over the elimination of ceilings, the fact that rate ceilings in other parts of the regulatory fabric have survived, and the widely held notion that rate competition ruined many banks in the 1920s and 1930s—this is a major step along the path to deregulation.

Nor is the phasing out of rate ceilings all that has been accomplished. The 1980 act also authorized automatic transfer accounts (permitting automatic transfers of funds between savings and checking accounts) for commercial banks, negotiable order of withdrawal (NOW) accounts for all depository institutions,[5] remote service units for S&Ls, and share drafts (the equivalent of checks, as are NOWs) for credit unions. In addition, savings and loan association powers were expanded to include broadened consumer lending powers, the issuance of credit cards, and the offering of trust services. State usury ceilings on mortgage loans and on business and agricultural loans above $25,000 were declared to be no longer applicable. And

[5] The significance of NOW accounts lies in the fact that, for all practical purposes, they permit the payment of interest on transactions balances (demand deposits).

truth-in-lending procedures were somewhat simplified. Finally, the statute contained a provision that, at least on the surface, promises further relief. Title VIII (cited as the Financial Regulation Simplification Act of 1980) requires that, in issuing a new regulation, federal financial regulatory agencies must ensure to the extent possible that its need is clearly established, that meaningful alternatives have been considered, that costs have been minimized, and that conflicts and duplication have been avoided.

That is about the limit of the deregulatory aspects of the statute, and that statute is about the limit of banking deregulation to date. These changes, of course, are not minor. The elimination of deposit rate ceilings, the broadening of thrift powers, and the authorization of automatic transfer, NOW, and share draft accounts will fundamentally change the retail financial services market. Competition will be greatly intensified—with some dramatic results (as we shall see).

The Bad News. Yet, our answer to whether there has been progress on deregulation remains yes and no. Much has been left undone, and some of what has been done goes in the wrong direction. For example, despite all the proposals for regulatory restructuring, nothing has happened in this important area beyond the creation of a Federal Financial Institutions Examination Council to coordinate policy and reduce inconsistencies in bank examinations. Prospects for real progress on restructuring seem slim at best, because of agency efforts to protect traditional turf and industry desires to keep a divided regulatory system that affords banks some flexibility and much greater leverage.

Similarly no action has been taken on geographic restraints. Since the departure of Senator McIntyre, Congress has not had a vocal champion of relaxed restraints, even for EFT facilities. Nevertheless, as we will note, a glimmer of hope remains.

Of greater concern are various proposals and actions for increasing the regulatory restraints on banking. One such scheme deals with the issue of concentration and is best exemplified by the repeated efforts of Senator William Proxmire (Democrat, Wisconsin) to set an upper limit or "cap" on a banking organization's market share. While this and proposals like it may seem a reasonable way to prevent anticompetitive dominance by a handful of institutions, they call for measurements based on unrealistic measures of the market (for example, the state) and of line of commerce (for example, commercial bank deposits).

The second competition-reducing scheme would limit the activities a bank holding company can undertake to those cited in a statutory "laundry list," rather than leaving this matter to the discretion of the Board of Governors of the Federal Reserve System. In my opinion, the board has itself been extremely conservative in permitting bank holding companies to engage in non-bank activities. Even that conservatism has not satisfied the forces of protectionism, with the result that litigation and major political campaigns have been launched, notably by insurance agents, data processors, and the securities industry, to further limit competition from bank holding companies.

More disturbing, and potentially far more harmful to the market's functioning, has been the imposition on commercial banks and other lenders of performance regulations for purposes other than bank soundness. Beginning with the Truth-in-Lending Act of 1968, Congress has adopted a basketful of new requirements that can be generally described as consumer

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protection regulation: the Consumer Credit Protection Act (1968), the Fair Credit Reporting Act (1970), the Fair Credit Billing Act (1974), the Equal Credit Opportunity Act (1974), the Real Estate Settlement Procedures Act (1974), the Federal Trade Commission Improvements Act (1975), the Home Mortgage Disclosure Act (1975), the Equal Credit Opportunity Act Amendments (1976), the Consumer Leasing Act (1976), and Debt Collection Practices Act (1976). While each of these measures has a laudable objective, they all (1) substitute

legislation and/or regulation for competition as a route to better performance, (2) assume that consumers cannot protect themselves, and (3) impose substantial reporting and regulatory costs that are passed on to consumers without evidence that the benefits received are equal to or in excess of these costs.

Moreover, in the past four years two additional statutes—the Financial Institutions Regulatory Act (1978) and the Community Reinvestment Act (1979)—have carried performance regulation into new areas. The first of these, adopted in the aftermath of publicity about the banking practices of Bert Lance, dealt with a wide variety of issues. While the statute's objectives are difficult to fault, its philosophical basis is troublesome. The original bill's title, the Safe Banking Act, implied an unsafe banking system, or large numbers of unsafe banks, or at the least that the questionable practices in which Lance had engaged were widespread among management of the nation's banks. Indeed, this last notion, although disproved by regulatory agency surveys, is reflected in the statute's first two titles—on insider transactions and preferential terms on loans related to correspondent accounts. Beyond the added costs involved, which are really not major, it is the attitude reflected in the statute that is of concern. There is a strong suggestion that, because of the unique nature of banking, the sale of banking services cannot be left to market discipline but rather requires special regulation even of banking transactions that do not threaten bank soundness.

Of greater concern to the banking community is the Community Reinvestment Act, where we find further evidence of the attitude noted above. This statute directs that banks meet the legitimate credit needs of their communities. An outgrowth of the "redlining" issue (the alleged refusal to make residential mortgage loans on property located in certain areas, basically urban low-income neighborhoods), many critics view it as nothing less than credit allocation by another name. And many others who do not share this view still believe the statute may foreshadow more explicit congressional or regulatory directives on the allocation or pricing of bank services.

One thing is clear: compliance with the Community Reinvestment Act is turning out to be extremely time consuming and costly. A bank must carefully define its community and must gather and maintain extensive records regarding the community, credit inquiries and applications, credit rejections, loans made, and the bank's sources of deposit flows. The federal regulatory agencies are requiring detailed examinations to check on compliance under this act (as well as Truth-in-Lending, Equal Credit Opportunity, and so on). A bank's community reinvestment record is to be taken into account in applications filed with regulatory agencies for approvals on branches, mergers, acquisitions, and office relocation. Opponents of an applicant can demand a hearing and protest the application on the basis of a bank's performance on the act's criteria. Such hearings and protests threaten to become handy weapons for opposing entry by those already in the market, and to offer a ready platform for all sorts of so-called public interest groups eager to criticize bank performance. Once again, while the objective may be laudable, the means are proving very costly, both for applicants and for regulatory agencies.

The bad news goes on. The Financial Institutions Deregulation and Monetary Control Act, whose virtues were cited above, also contains new regulatory burdens. Its monetary reform provisions impose FRS reserve requirements on the transaction accounts of *all* depository institutions, thus bringing about a "level playing field" by imposing new regulatory burdens on those not previously covered, rather than by reducing the burden on those already subject to reserve requirements. These new costs were imposed without clear evidence that they are needed for effective monetary policy. The act also prohibits, though only for a year, the interstate acquisition of a non-deposit trust company by a bank holding company.

Finally, let me note in passing troubling signs even in the deregulatory portion of the Financial Institutions Deregulation and Monetary Control Act. For example, although Congress approved automatic transfer services, NOW accounts, and share drafts, all of which amount to somewhat cumbersome and expensive versions of interest-bearing checking accounts, it did not deal with the issue directly by removing the prohibition of interest on demand deposits. In addition, there is the very appreciable irony of the Depository Institutions Deregulatory Committee's first move,

which was to propose not deregulation, but a ban on the use of gifts and premiums to attract deposits—a peculiar way to deregulate restraints on competition for deposits.

It is possible to read further ominous signs in the action taken by the Federal Reserve System in March 1980 to impose strict anti-inflationary controls on credit. Rather than relying on tighter control over money supply growth, a policy initiated in October 1979 under Chairman Paul Volcker, or on the more traditional manipulation of interest rate levels, the FRS turned to a variety of selective credit controls under the authority of the Credit Control Act of 1969, the first use of those powers.

"Promises, Promises". Looking ahead, what is the likelihood of further deregulation in commercial banking? The prospects seem good on one front only—geographic restraints on competition. The forthcoming McFadden report,

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which is expected to recommend that these restraints be eased (especially for EFT facilities), will serve as a useful basis for legislative recommendations in 1981. Given the politics of geographic restraints, this issue can probably be fully aired only in a non-election year. Besides, the proposal is fully in accord with the theme of the deregulatory movement—to remove restraints on competition. This has been true of airline, trucking and, to an extent, railroad deregulation, and of parts of the Financial Institutions Deregulation Act as well.

There are other reasons for anticipating a cutback in geographic restraints. Technology, along with the commuting, shopping, and recreation habits of individuals, render such limitations inconsistent with public convenience. With the development of new financial services, the importance of economies of scale grows almost daily, and those economies are difficult to achieve under severe geographic restraints. Commercial banks face increasingly vigorous competition for individuals' savings and other services from institutions for which geographic restraints are less severe or are nonexistent. Finally, an optimistic note has been sounded by the courts in striking down an effort of the Florida legislature to prohibit out-of-state holding companies from acquiring trust companies. This bodes well for the future, should federal geographic restraints be relaxed and interstate expansion be challenged by the states.

The Bottom Line

To restate the questions posed at the outset,

- is banking experiencing a net reduction in regulation, and
- what will be the impact of the changes that have occurred?

To answer the first question, it is important to remember the three principal objectives of banking regulation: (1) to prevent undue concentration of power, (2) to provide for safety and soundness, and (3) to ensure performance in meeting society's goals. On the first objective, whereas it has been pursued in the past by placing controls on growth (for example, rules governing branching, mergers, and acquisitions), it seems clear that forces are at work to set aside the controls in favor of relying more heavily on competition.

With regard to safety and soundness, there is no move toward deregulation. New techniques are being devised, some of which increase and some of which decrease the burden of regulation. There are efforts underway to reduce the likelihood of large bank failures, and the Financial Institutions Regulatory Act has imposed new regulatory burdens associated with safety and soundness. On balance, there is a gradual trend to greater regulation.

In the area of performance, there is significant movement toward increased regulation, exemplified by the Community Reinvestment Act. If rapid inflation and high interest rates continue, with their effects on resource allocation, this trend can be expected to persist or even intensify.

Despite the apparent contradiction of less regulation in some areas and more in others, some of the probable effects of these developments are fairly clear. Competitive deregulation, if significant relaxation of geographic re-

straints is added to the phasing out of deposit rate ceilings, will fundamentally alter the competitive environment, the pricing of bank services, and the structure of the banking industry. The number of competitors in local markets now characterized as monopolies or oligopolies will increase. At the same time, the number of banks will decline sharply over the next twenty years, perhaps by a third or a half. Accordingly, average bank size will rise sharply, with most of the change involving consolidations among small and medium-sized banks. The trend toward putting explicit prices on all bank services will spread. Large depositors will no longer subsidize small ones, nor will depositors as a group subsidize borrowers. Idle account balances will yield a rate of return reflecting market conditions less the costs of maintaining those accounts (and handling transactions). Savings at regulated depository institutions will be more remunerative and may, in consequence, increase as a percentage of disposable personal income.

The result would seem to be that net savers will benefit, but not as much as they might have in the absence of greater performance regulation; and net borrowers will pay higher costs, though not as high as they would have if banks had been denied the opportunity for more equitable competition with non-deposit institutions. Competition will be shown to work. Unfortunately, the changes that accompany its working—structural shifts, higher credit costs, and a significant redistribution of the burden of costs among users of financial services—will

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lead to criticisms that may undermine its support. Ideally, competitive deregulation should reduce the need to control performance directly. The danger is that the critical voices will succeed in undoing the deregulation or in so expanding performance controls as to offset the benefits greater competition can bring. ■

Rate-of-Return Regulation

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the existing industry but also competition among similar industries offers consumers better protection from monopoly power than rate-of-return regulation. Thus, for example, in the early days of railroads, more public attention to the state of the roads might have generated earlier and better alternatives to the railroads for very short hauls. Ultimately, of course, the advent of trucks provided precisely that kind of competition (which then got regulated also!).

Similar competitive possibilities are arising today in communications. Competition to traditional local telephone companies that interconnect telephones by wire could come from wireless systems—two-way radios that operate on new frequencies—or systems that combine radio and wire links. A few relatively modest changes in regulatory restrictions on the use of existing radio systems could open the way to such competition. Similarly, new video technologies such as cassettes and discs, as well as more relaxed rules on subscription and low-power television stations, could be more effective anti-monopoly techniques than state or local rate regulation of cable television systems.

(4) *Antitrust restrictions.* When a monopoly offers a multiplicity of closely related services, its power to abuse can be held in check by antitrust restrictions against tie-ins and refusals to deal. For example, government could require that, insofar as a firm is a monopoly, its various services be offered individually and be subject to resale. These two techniques—unbundling (requiring, for example, that the telephone service and the telephone set be offered separately) and resale (allowing the customer to share his purchase with other users and to charge for that sharing)—would impose pressures to keep charges close to costs and induce competitive offerings of at least some services.

So SOCIETY DOES have techniques available for reducing monopoly power. These alternatives all involve governmental intervention in markets. Some even involve regulation—but not rate-of-return regulation. Going that route, no consumer has yet been protected from abuses of monopoly power, nor ever will be. It is both a snare and a delusion—and an unacceptable fraud on the public. ■