

Regulation Tomorrow: Toward a New Framework for Competition

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Not long ago, a thoughtful banker spoke on the theme that "banking isn't fun any more." We all know what he meant: the regulatory burden of banks is becoming heavier and seems to be getting in the way of a banker's ability to do the job he wants to do in his community.

More than 15 major new pieces of legislation affecting banks have been sent forth from Congress in just the past decade or so. As a regulator, I am sensitive that we are more or less in the middle—striving to adjust to the constant demands of new legislation while seeking to continue to serve banking effectively. With the onrush of regulations, however, some days it isn't fun any more for the regulators either. But it's not hopeless. There are good opportunities ahead for thoughtful bankers to work with regulators and legislators to develop a financial system that acknowledges the complementary needs of financial institutions and the public. Moreover, the opportunity for all like financial institutions to compete on an equal basis—including S&L's, mutual savings banks, and others—should be the central theme of our mutual efforts. I am convinced that a financial system which permits the principles of the free market to operate,

unfettered by oppressive regulation, is the most efficient way to allocate the total financial resources of our nation.

Much of the current regulatory framework is a heritage of the traumatic 1930s, when laws were implemented to restore public confidence in the banking system. These laws emphasized the protection of bank depositors and the prevention of bank failure.

Experience confirms that many of these laws, such as the one creating the Federal Deposit Insurance Corporation, served their purpose well. Other laws, however, written for another time and another purpose, now serve only to reduce competition without appreciably improving bank soundness and safety. A key example is interest payment restrictions on demand and savings deposits, originally designed to prevent "excessive" competition among banks.

The regulatory legacy of the '30s is still with us today. However, recent changes in technology, together with the growing competition from nonbank financial institutions and continuing inflationary pressures, have resulted in strong incentives to alter piecemeal much of this regulatory structure. Although the soundness of our financial system must continue to be of paramount concern, increasing emphasis needs to be given to competitive

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considerations if banks are to compete effectively with other financial institutions and continue to serve the deposit and credit needs of the public. Thus, I believe increased emphasis on enhancing competition should be a primary ingredient of future bank regulation.

PAYMENT OF INTEREST ON DEPOSITS

One major area in which legislative and regulatory reform will significantly increase competition—and ultimately economic efficiency—is the payment of interest on all types of deposits. The regulations on ceiling interest rates and the outright prohibition of interest on demand deposits are rooted in the Banking Acts of **1933** and **1935**. These laws arose out of the dangerously unstable condition of our banking system in the depths of the Depression. Since that time, Congress has extended this ceiling rate authority 13 times, most recently through Title **16** of the Financial Institutions Regulatory and Interest Rate Control Act of **1978** (FIRA), which extends it through **1980**.

In the past few years, pressure has been mounting to eliminate the prohibition against the payment of interest on demand deposits and to phase out what we know as Regulation Q ceilings. These pressures stem from two sources: the rise in the inflation rate, and the public's desire to receive a fair rate of return on deposits. As recently as **1976** the six-month Treasury bill rate was **5.25** per cent, about the same as the Regulation Q ceiling on passbook savings. Since that time, however, the Treasury bill rate jumped to **9.5** per cent in **1979**, while the passbook ceiling rate for commercial banks remained at the **1973** level of **5** per cent until July **1** this year, when it was raised to **5.25** per cent. To compensate for the disparity between market rates and those allowed under Regulation Q, new savings instruments have been introduced. The result has been the slow evolution of a complex array of time and

savings instruments with varying interest rates and maturities. These instruments, now in **15** varieties, have confused savers, have led to discrimination among classes of savers, and may have lessened the incentive to save.

Depositors, however, are not the only ones penalized by interest rate ceilings. Regulated financial institutions are also hurt. While financial institutions have experienced increased operating costs associated with the multiple types of instruments available to depositors, they have also suffered serious problems of disintermediation during periods when market rates have risen above those allowed under Regulation Q.

Although some argue that interest rate ceilings are necessary to ensure a source of stable and low-cost funds to the borrowing public, the ceilings have not provided that result. Rather, the flow of funds away from institutions subject to Regulation Q provisions has periodically caused a shortage of funds for borrowers at times when these institutions could not compete with other market rates.

Our recent experience with interest rate prohibitions and ceilings has been less than satisfactory. The problems they have created have led to increased regulatory and legislative efforts to do away with or sidestep them. For example, the NOW accounts permitted in New England and New York provide depositors an interest-bearing transaction account. Automatic transfer services and bill-paying arrangements, until struck down by the U.S. Court of Appeals this past April, provided depositors outside New England and New York with an indirect method of earning a return on demand balances. Currently, bills are pending in Congress which would phase out or abolish interest rate prohibitions and ceilings, and the current Administration has put its support behind a gradual phaseout of all deposit interest rate controls. In my judgment, one result of these trends and developments is that

we are on the threshold of having Federal legislation to authorize NOW accounts for like financial institutions—including banks—on a nationwide basis.

BRANCHING RESTRICTIONS

Another area where legislative and regulatory change is likely to result in increased competition is the further relaxation of branching restrictions on financial institutions.

In recent years, the branching topic has become increasingly important, as technological progress and the growing incursion by other institutions into the traditional banking service areas have required greater competitive flexibility for banking. Advances in electronic payment mechanisms and the sharing of facilities by different banks and other financial institutions have led to the development of statewide and regional electronic transfer systems. With the growth in electronic banking has come an erosion in the importance of political boundaries in governing competitive interaction among financial institutions. Banks have, or soon will have, the capability to serve their customers electronically over great distances. Restrictive state branching laws, which did not anticipate such advances or the ability to perform interstate and even international business through loan production offices or Edge corporations, must adapt if our banking system is to compete effectively with other financial and nonfinancial institutions which are unfettered by such restriction.

To the extent that state branching laws are not sufficiently flexible to allow banks to compete with these new technologies, they will force the creation of innovations to circumvent their restrictions.

In my judgment, technological and competitive considerations will bring increasing pressure for reform in state branching laws. This reform may come in fits and starts, with development of reciprocal branching agree-

ments among states and the linking of EFT systems. But most of us would prefer that reform evolve in a more comprehensive and efficient manner by allowing nationwide linking of electronic systems among many types of financial systems while clearly defining the allowable types of transactions. Such an approach would assure that no state would be left at a competitive disadvantage and would allow financial institutions to plan for the future in a more certain environment.

RESERVE REQUIREMENTS

Another competitive issue is reserve requirements. Member bankers feel strongly that the cost of holding idle reserves has hindered them in competing with nonmember banks and other financial institutions. And as more and more types of institutions begin to offer transaction services, greater attention will have to be focused on establishing equitable reserve requirements. Increasing competition for sources of funds, rapid inflation, and high interest rates have combined to force bankers to take a close look at the cost of membership. Many banks have reacted by withdrawing from the System. From 1945 to 1970 the proportion of U.S. banking deposits controlled by member banks fell from 86 per cent to 80 per cent, and from 1970 to 1979 shrank to 72 per cent, complicating the Federal Reserve's task of implementing monetary policy. Aside from the membership implications of the reserve burden, a number of economists have attacked the present system of required reserves as inefficient, saying it allocates resources poorly. They question whether a desired level of investment in banking can occur relative to other industries if bankers are required to hold a portion of their assets in nonearning balances.

Thus, if our banking system is to be competitive with other financial institutions, both here and abroad, and with other industries, the burden of idle reserves must be

eliminated. As well documented in discussions of the membership issue, lower reserve requirements and/or the payment of interest on reserves are the two primary methods suggested for lessening this reserve burden.

Member bankers may be assured that the Federal Reserve Bank of Kansas City will continue to urge an early resolution of the membership issue and an easing of the reserve burden.

SUMMARIZING THE ISSUES

In summary, we know now that some of the 1930s banking legislation serves only to reduce banking competition without producing any measurable gains in the efficiency of the banking system. Moreover, as a result of restrictions on bank activities and deposit interest rates, and partly as a result of banker attitudes, the role of commercial banks in the financial sector has been gradually usurped by other financial institutions and new credit arrangements. This change has become more rapid since the late 1960s, as the burdens of interest ceilings and reserves have increased with inflation, and technology has fostered new payment practices. Banks have been particularly vulnerable to this combination of circumstances, given the nature of their assets and their special need to attract both deposits and capital.

What concerns me most about the recent financial growth and development outside the banking sector is that it has occurred mainly because banking laws have been too slow to adapt to changing conditions and the demands of the public, and not because banks have lost their desire to deliver financial services in an efficient way. Therefore, bankers and regulators should both have a strong interest in developing and supporting a new regulatory

framework which ensures that commercial banks are allowed to offer competitive services to the public. At the same time, that framework must preserve the essential features which contribute to a sound banking system deserving of public confidence.

If we continue to embrace the outdated and largely anti-competitive aspects of the banking laws of the 1930s, the morass of piecemeal, patchwork fixes so characteristic of legislative and regulatory response will continue to hold us back.

Change, and now accelerating change, has brought us a new ballgame. It demands a comprehensive understanding of how the game is to be played, not rules made up as the game goes along. We all should support a fundamental review of the environment in which financial institutions operate and compete today, with a view toward legislating a financial system which recognizes the importance of improved competition and economic efficiency in the financial arena.

As these issues are aired in national forums in the period ahead, I know that thoughtful bankers will continue to draw upon their experience to counsel their lawmakers and regulators. I hope that legislators will consider fully the traditional principles of free enterprise in their decisionmaking. I hope we can establish a financial structure in which all like institutions can compete equitably. Let us have reasonable equity in requirements for capital, liquidity, and taxation. Let the marketplace decide what institutions should provide what services and at what prices.

As change inevitably occurs in banking, and as bankers and regulators join to encourage a responsive regulatory framework for financial institutions, the Federal Reserve intends to support a system that acknowledges the needs of both banks and bank customers.