The Uncertain Course of Bank Deregulation

Kenneth E. Scott

IN MANY QUARTERS there is a belief—be it hope or fear—that a mood of deregulation is sweeping the country. A prime candidate for such a movement would certainly be the banking business—one of the first industries in the United States to be regulated and by now probably the most thoroughly and extensively regulated of all. And in fact 1980 did see the enactment of the Depository Institutions Deregulation and Monetary Control Act. That title is something of an exaggeration, however, and the prospects for deregulation in the banking business are far from clear.

Most of the intricate mass of bank regulation is left quite untouched by the 1980 act. The cumbersome and outmoded tangle of provisions dealing with portfolio regulation is preserved intact. Truth-in-lending was simplified, if that is the proper word, by another twenty pages of statutory enactment. And reserve requirements were extended to all banks and to thrift institutions (mutual savings banks and savings and loan associations) in the most sweeping expansion of federal regulation in that domain since 1913.

Kenneth E. Scott is professor of law at the Stanford Law School and senior research fellow at the Hoover Institution.

What the 1980 act does represent is a dismantling of the anticompetitive cartel structure that was created by the Banking Act of 1933. The Banking Act, in a manner consistent with the economic thinking that characterized that period, sought to deal with the problems of the depression by creating an industry cartel to divide markets and fix prices, in the name of preventing that excessive competition which was seen as the major cause of business failure and economic depression. In essence, the Banking Act of 1933 undertook to create a buyers' cartel among banks, restraining competition among them for demand deposits and for time and savings deposits. Under the cartel the maximum rate of interest payable for time and savings deposits was to be established through the regulatory agencies, the Federal Reserve Board, and the Federal Deposit Insurance Corporation (FDIC), while the maximum rate to be paid on checking accounts was fixed in the law itself, at zero. The 1980 deregulation act memorializes, more than anything else, the collapse of this cartel.

I

Under Title II of the act, the interest ceilings on time and savings deposits, commonly known as Regulation Q, are to be phased out over a six-year period. In the findings and purpose clause, Congress purports to discover for the first time that interest rate ceilings discourage persons from saving money, create inequities for depositors, impede the ability of depository institutions to compete for funds, and have not achieved their purpose of providing an even flow of funds for home mortgage lending. Most economists and other students of the subject, of course, had discovered all that some decades ago. On its face, Congress has decided as a matter of principle to stop penalizing smaller savers and to start encouraging capital formation, and has brought to an end its recent policy of trying to make savers subsidize home mortgage borrowers.

Why did Congress take this step in 1980? It is not, I would suggest, because its members gained economic insight previously denied them. Instead, it is because the buyers' cartel created by the Banking Act had largely disintegrated, and for the usual reasons. Cartel members have a laudable tendency to cheat on each other by deviating from the established price. In this case, they have been offering premiums and finder's fees and free services for years. Along with fixing prices, cartel members have to agree on a division of the market, and that is always a fertile source for disputes and infighting and ultimate breakdown. In this case, the fighting between banks and savings and loan associations over the role of the differential (between the ceiling for bank savings deposits and the quarter-point higher ceiling for S&L savings accounts) and their respective market shares has become ever more intense. In addition, price-fixing arrangements cause a cartel to lose customers to firms that are outside the cartel and can pay market prices. In the banking business, this phenomenon was seen first in the salutary process known as disintermediation (as depositors withdrew funds to invest directly in the capital markets) and then in the rise of new intermediaries outside the cartel—money market funds in particular. When enough of the cartel members conclude that their arrangements are no longer beneficial, they will break up. Since this cartel was originally achieved through legislation, its breakup takes the form of a repeal of that legislation.

But the outcome here is not yet free from doubt. Some members of the cartel hope that it can still be patched up—that the dissidents can be forced back into line, that the controversy over the differential and market shares can be resolved, and that outside competitors such as money market funds can be brought under control or forced into the cartel also. On the one hand, Title II calls for the elimination of Regulation Q, but on the other hand, it extends rate control authority for six years—the longest extension it has received since the new era of 1966 when S&Ls, which were then outside the cartel and had been vigorous competitors, were brought within the cartel by legislation.

The 1980 bank deregulation act memorializes, more than anything else, the collapse of the anticompetitive cartel structure created by the Banking Act of 1933.

Though it is under severe strain, therefore, the savings account cartel is not yet definitively broken, and the struggle continues. The S&Ls want to preserve their rate differential, which is why the banks have concluded that on balance they want out of the cartel. At the very least, the S&Ls would like to shift the phase-out regulatory authority from the Depository Institutions Deregulation Committee, where their representative is in a minority, to the more favorable setting of the Federal Home Loan Bank Board acting alone or through a veto. Both the banks and S&Ls agree that the money market funds should be hobbled, because the funds are paying market rates to smaller savers—the supposed objective of Title II. "Housing," of course, serves in its customary role as the rationale for all of this.

The second major feature of the 1980 act was the authorization of nationwide NOW accounts in Title III, otherwise known as the Consumer Checking Account Equity Act. The enactment of this title commemorates the well nigh total collapse of bank control over checking accounts. Back in 1933 banks had a legal monopoly over checking, so that when the Banking Act of that year fixed the rate of return on checking accounts at zero, there were no firms outside the cartel in a position to undermine it. But the product monopoly eroded over time, as other financial institutions developed close substitutes for checks, which they proceeded to do when it became highly profitable. Checking account balances became very valuable when market interest rates started climbing well above the old 2 to 4 percent levels that characterized much of the period from 1933 to 1964. From the late 1960s through the 1970s, market rates moved to ever higher levels, and other financial institutions started devising ways to attract checking account business. The mutual savings banks came up with negotiable orders of withdrawal (NOW) as a device for converting savings accounts into a species of checking account, and in 1972 won a court battle over its legality. In the last years of the 1970s, the S&Ls started offering bill-paying services and affording immediate and easy access to savings account balances through remote service units, while credit unions devised share draft accounts and money market funds began making withdrawal orders or pay-through drafts available to their customers also. All of these check substitutes have one element in common—they pay a higher rate of interest than zero. In an attempt to hold their market shares against such competition, banks developed automatic transfer services and zero balance checking, with the approval of their regulatory authorities.

By the end of the decade, this aspect of the 1933 cartel was in ruins: banks no longer had a monopoly on checking accounts, and there was widespread payment of interest on checking account balances. The U.S. Court of Appeals for the District of Columbia Circuit, with its usual economic acumen, briefly propped up the crumbling cartel by its 1979 decision in *ABA* v. *Connell*, which invalidated the entire decade of financial innovation. But the weight of political force was now outside the cartel, and Congress overturned the court of appeals' decision in Title III of the 1980 act, by authorizing all of the various substitutes for checks and extending NOW accounts nationwide. Thus, in substance if not in technical form, the prohibition against paying interest on demand deposits was repealed in the 1980 act for individuals (though not yet for businesses).

II

It should not come as a surprise that the 1933 bank cartel disintegrated, for cartels are inherently difficult to maintain, but one may still ask why that occurred in 1980 rather than earlier or later. One can seek explanations on many different levels, ranging from the vagaries of political personalities and end-of-session maneuverings to broad trends that work throughout the economy. The latter are the more relevant to my inquiry here, and I want to emphasize two major forces.

The most important single factor bringing matters to a head by 1980 was the Federal Reserve Board's conduct of monetary policy and the resulting inflationary swings over this decade that drove nominal interest rates first to the 10 percent and then to the 20 percent level. To put it another way, the effect of inflation is to drive down the real interest ceiling that is imposed by a fixed nominal rate, such as 5¼ percent or 0 percent. The ceilings become negative in real terms, so that depositors are paying the depository institution to take their money. So when nominal interest rates are going up, fixed ceilings become ever more costly to depositors. Concomitantly, there are created strong financial incentives to find a way around the ceiling. That is precisely the situation that characterized the decade of the 1970s, and in particular the last two years.

Second, the destruction of the cartel was assisted by another development that started to be felt in the 1970s—namely, the technological advances that are lumped under the acronym EFT (electronic funds transfer). The products and markets of depository institutions, like those of any industry, reflect existing technology. As the production costs of banks and the access costs of their customers change, so will the structure of the industry.

For example, branching was not an important issue in nineteenth century banking. Some banks had branches, but most did not, and nobody much cared. The subject was not even mentioned in the National Bank Act of 1864. There was no particular advantage to branching, beyond a small distance at most, at a time when communication and travel were slow and expensive. That state of affairs changed beginning around 1910 and especially after 1920, under the impact of the telephone and automobile. These technological advances lowered transportation and communication costs for banks and their customers and thereby expanded banking markets and increased scale economies in banking.

The electronic and computer revolution that began after World War II and accelerated in the 1970s is having a similar impact. Geographical markets in banking have again expanded and economies of scale have again increased. These technological advances have helped destroy the product monopoly and market division structure created by the Banking Act of 1933. Non-banks can offer demand deposit and check substitutes over a wide area through EFT networks, consisting at this point mostly of automatic teller machines (ATMs). The Federal Home Loan Bank Board has facilitated this process by encouraging the deployment of remote service units.

III

Against this background, what may we expect in the 1980s? Predictions are always hazardous. The most dismal part of the dismal science of economics is its forecasting record, and certainly lawyers can claim no comparative advantage in this exercise. Let me plunge ahead, however, exploring the implications of two premises. First, the economic trends of the 1970s have not yet spent their force or had their full impact. Second, the provisions of the 1980 act become a new factor, which will have its own effects.

Beginning with the first, should we regard high and volatile rates of inflation as a thing of the past, to disappear under the new administration and the new Federal Reserve Board? Perhaps, but we have heard those claims before. What if the future is like the recent past? It is clear that enormous strains are being placed on thrift institutions, with their inherent imbalance between the maturity structures of their assets and their liabilities. Two types of responses are to be expected: (1) For some time there have been efforts to reduce that maturity imbalance, by affording thrift institutions more short-term assets and more long-term liabilities. Indeed this trend is visible in the 1980 act itself. Title IV allows federal S&Ls to invest in consumer loans, commercial paper, and corporate debt securities. These measures are economically sound and desirable, but bit by bit they move thrift institutions from being an intermediary confined to housing investments to being more of a broad-spectrum financial intermediary. Since that undermines its proven formula for political success, the thrift industry is less than wholeheartedly enthusiastic about such measures. (2) Efforts are being made to shelter thrift institutions from the forces of competition or to obtain subsidies for them, at the expense of savers or taxpayers. Examples are the industry's drive to hamper money market funds, to maintain or enlarge its rate differential, and to obtain an increased income tax exemption for savings account interest. It is all supposed to be justified in the name of helping housing or helping the poor, even if the supporting arguments and evidence seem thin. There is very little reason to believe that deposit rate ceilings result in lower

"Mr. Arnold, this is Buddy, in Small Loans. Can we spare a dime?"

borrowing costs for home buyers, for example, and even if they did, it would be a grossly inefficient way to help the poor. What rate ceilings do ensure is that the poor shall not earn market rates on savings. But in Congress, it does not matter if the arguments do not hold up, so long as the political coalition does.

Both types of efforts serve the interests of thrift institutions, and no doubt the industry will try to have it both ways—seeking expanded investment authority and greater fund-raising flexibility, while also seeking legal shelter from competition and various forms of government assistance in the name of housing. But in the long run, the first strategy undercuts the second, as it takes thrift institutions more and more in the direction of being a general intermediary and away from being a mere housing prop. A continuation of this process should ultimately lead to the dominance of the first strategy, which is the only way the thrifts can overcome their structural unsoundness.

The other economic force that I mentioned was the growth of EFT technology. So far, we are not even close to realizing the full potential of EFT. There are in place relatively small networks consisting of dozens or hundreds of ATMs, but the maximum savings from this technology will come from networks consisting of thousands of point-of-sale (or even home) terminals. As this evolution continues, scale economies and geographical banking markets are again being increased. The remaining pieces of the old bank cartel—the barriers to competition in natural market areas—will come under increasing assault. Unit banking laws, and the notion that there is something terrible about bank competition across state lines, seem sure to be effectively undermined or completely eliminated before the decade is out.

Adding to these economic forces will be the effects of the 1980 act itself. A number of its features point toward more competition and lower profits for the isolated or monopoly bank. As we have noted, the checking account monopoly of banks has ended de facto if not de jure; S&Ls, mutual savings banks, and credit unions have now entered the field, while money market funds, brokerage firms, and national retailers are poised on its outskirts. At the same time, the ban on the payment of interest on demand deposits has also ended, except for business deposits. (The latter prohibition was never really significant, since it was more easily circumvented. But even this last remnant of the interest prohibition is not likely to survive.) The natural geographic market areas for banking services are expanding, which means more competition from other banks, as well as from S&Ls and credit unions which are not hobbled by a counterpart of the branching limitations imposed on national banks by the McFadden Act. Small state banks in particular, which have historically not been members of the Federal Reserve, will now experience a new tax through the form of the mandatory reserve requirement imposed on them by the 1980 act. All of these factors will come together with increasing force, bearing particularly upon those banks that have heretofore been the most sheltered from competition.

The 1980 act also brings S&Ls into a much more competitive environment. The protection afforded them by interest rate ceilings and their cherished differential are on the way out, or so we are told. Their investment powers are increased, but the markets that they will be entering are already in most instances highly competitive. And their forays into the world of transaction accounts will now likewise be burdened with a reserve requirement. Meanwhile, inflation has devalued their mortgage portfolios, creating solvency problems quite apart from the effects of Regulation Q or its elimination.

IV

When one puts this all together, what impends? Some major trends seem clear. First, our artificially balkanized banking structure will move toward a more efficient configuration, with fewer firms, of substantially larger average size, operating within natural market areas. That does not mean that small banks will vanish or that only a handful of giants will survive. It does mean, however, that many existing firms will disappear. The nonprice competition for deposits that has marked much of the last two decades has led to overinvestment in branch capacity for many institutions; the liquidation of that excess capacity is sure to produce some capital losses. Enhanced competition will have its normal, and desirable, effect of eliminating those institutions that are not competently managed or not efficiently diversified.

Our present structure of 14,000 commercial banks, 5,000 S&Ls, and 20,000 credit unions is hardly optimal. As market segmentation ends, that diffuse institutional structure will coalesce into far fewer entities. The extent of this shakeout should not be underestimated. One very crude and simple approximation can be derived by projecting the banking structure of a state like California, which has operated since 1909 with statewide branching and a low level of market entry barriers, to a national scale. If that is done, the result is a banking system of around 2,000 commercial banks, with over 10,000 of the units lost being the small ones (under $50 million in assets). Even if these rough numbers were doubled, they would still suggest the potential for disappearance of over 70 percent of the institutions now comprising our banking system. While markets would be more competitive, the total number of firms would be much smaller, in national terms.

From a public standpoint, it is critical whether the shrinkage occurs through merger and acquisition or through bank failures. If it occurs by failure, there will be major drains on the resources of the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, and the National Credit Union Share Insurance Fund—which predictably would lead to political uproar. To lessen that prospect, the banking agencies have recently again proposed legislation to facilitate supervisory mergers or holding company acquisitions across state lines. That proposal may have gone too far politically for the last Congress, where it never came to hearings, but it does not go nearly far enough in economic terms. Mergers and acquisitions, within antitrust standards, should be encouraged—and certainly not barred by phobias about state or industry boundaries—long before the institution becomes a problem case.

As depository institutions experience these pressures in the 1980s, they will probably become much more concerned about activity restrictions that keep them from offering services in which they have some degree of comparative advantage and profit potential. The argument about the harmful consequences of combining banking and commerce in a single company, on which the Nixon administration relied in enacting the Bank Holding Company Amendments of 1970, was always a straw man. During the previous 200 years of our banking history, there was no legal impediment to the combination of banking and commerce under a single parent company. Why then did we not see that dreaded combination of Chase Manhattan with U.S. Steel, or Citibank with DuPont? The answer is much the same as why we do not see McDonald's combining with MGM, or Levi Strauss with General Foods. The combination has no economic advantage but significant diseconomies of management. There are, however, economic advantages in banks or S&Ls expanding into some related lines of financial and consumer services. While the 1970 pressure group tug-of-war in Congress did not lead to incorporation of a "dirty laundry list" of forbidden activities into the law itself, that list seems to have largely guided the Federal Reserve Board ever since its interpretation of the vaporous statutory standard of being "so closely related to banking . . . as to be a proper incident thereto." The result has been to keep banks from offering, and customers from being able to take advantage of, convenient service packages.

Even if it does not make good economic sense to prevent bank customers from reaping the benefits of economies of scope or scale, it may make good political sense for members of Congress to vote that way. The pressures of the 1980s seem likely to heat up a political fight that has been largely dormant since 1970. Whether it will erupt into a major and successful battle, however, is harder to foresee.

IN CONCLUSION, let me stress, not these attempts at prophecy, but a basic principle: The public interest is served by efficient intermediation, not by the preservation of a particular market structure or set of intermediaries. Our present position is the result of a number of waning forces, as well as some misguided legislation; it is not an ideal system to be maintained unsullied by change. It is to be hoped that the sloganeering about housing or level playing fields will not cause us to lose sight of that point. ■

This paper was presented at a colloquium entitled "The Deregulation of Depository Institutions," held at the Berkeley Business School on March 19, 1981, and funded in part by the U.S. Comptroller of the Currency.