Expanded Powers for Depositary Financial Institutions

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One service the Hunt Commission has performed for us all has been to remind us how interrelated many aspects of the nation's financial system are. I do not mean by that to suggest that each of its numerous recommendations must be adopted if any one of them is, because this is manifestly not the case. I am suggesting that once the Commission made the basic policy decision that it would seek to promote competition in the same market on substantially equal terms for all depositary institutions, the thrust of its basic recommendations, particularly those dealing with interest rate ceilings on deposits, operating powers, reserve requirements and taxation, could have been predicted. What must now be decided is whether the financial system proposed by the Commission – compromises and all – will serve the country significantly better than the system we now have – a system one bankers has tagged as "balanced inequality." If we have doubts on that score, can the framework for reform suggested by the Commission be improved?

The Commission was formed, as we know, after two relatively lengthy periods of tight money in which deposit institutions had lost a significant volume of funds because the ceiling rates allowed to be paid on deposits were well below market rates on long-term investments. This deposit outflow adversely affected the funds available for residential housing and smaller businesses throughout the country. It was not surprising, therefore, that the Commission was given a broad general mandate to recommend improvements in the nation's financial system with more specific mandates in three areas: (i) mortgage financing, (ii) the role of interest rate ceilings, and (iii) the need for flexibility on the part of deposit institutions to permit a sensitive response to changing demands. While the Commission's report includes a number of relatively minor reforms in mortgage lending practices that should be implemented regardless of what

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happens to the rest of its recommendations,[1] the fundamental changes it proposes are the eventual removal of deposit rate ceilings, a wider authority for all institutions to bid for lendable funds, and much broader asset powers for the so-called specialized deposit institutions, namely mutual savings banks and savings and loan associations.

Removal of Regulation Q Ceilings

The most basic of these recommendations is the eventual removal of Regulation Q-type ceilings for all deposit institutions. If implemented, the change would remove the discrimination that presently exists between depositors with more than $100,000 and those with less than $100,000. It would also abolish the distinctions that presently exist between the rates which thrift institutions can pay and those which commercial banks can pay – a distinction that inhibits the growth of commercial banks without ready access to nondeposit sources of funds. More to the point, this change would give all deposit institutions an opportunity to compete effectively with market instruments in future periods of monetary restraint thereby blunting the forces of disintermediation, attendant liquidity strains, and sudden reductions in the availability of lendable funds. These benefits could not be realized, however, unless deposit institutions were in a position to respond promptly to increases in market rates particularly on instruments attractive to depositors. Their ability to do so will obviously depend on yields in their asset mix, their cash flows, the speed with which they can change to higher yield investments if this should be necessary, and the level of retained earnings available for temporary use if current earnings cannot meet a significant increase in the interest expense on deposits.

In order to bid competitively for deposits in a world without ceilings, deposit institutions would all have compelling incentives to maximize earnings. A high level of earnings on a current basis relative to other competitors would allow an institution to move upwards in rate as quickly as possible when the market required, and if market

[1] E.g., authorization for variable rate mortgages, the removal of administered ceilings on FHA and VA mortgages, the repeal of state usury ceilings and other unreasonable restrictions on residential mortgages, simplification of the legal work in mortgage originations and foreclosures, permitting loans to be made on properties anywhere in the United States, further encouragement for secondary market operations for mortgages and the abolition of "doing business" barriers which some states place on out-of-state institutions lending money on or holding real property within their borders.

rates allowed some stability in interest expense, maximum earnings would permit an institution to add to its retained earnings for possible use at some future date when income on a current basis might be insufficient to meet a rapid upswing in interest expense. The necessity to maximize earnings so as to be ready for upward movements in market rates – whether precipitated by monetary conditions or the actions of a competitor – makes me question the distinctions that would remain, even under the Commission's recommendations, in the asset powers of different types of institutions.

Asset Powers

I would have thought the logic of the Commission's recommendation on deposit rate ceilings would have led to a recommendation that all institutions have exactly the same asset powers. Such a recommendation would also have been more consistent than the Commission's actual recommendations with its guiding principle of equality for all competitors in the same market. As it is, some important differences remain – dictated presumably by considerations of historical emphasis or political acceptability. Thus, commercial banks would continue to be the exclusive suppliers of short-term credit to American businesses and only they could offer checking account services to business firms. As a result, the average commercial bank might continue to have a loan portfolio of relatively shorter term than the average thrift institution, with consequent advantages when interest rates are rising and corresponding disadvantages when interest rates are falling. Mutual savings banks and savings and loan associations, on the other hand, would have under the Commission's proposals an authority denied to commercial banks to invest for their own account in equity securities listed on a national exchange, as well as fewer restrictions than commercial banks on the use of the proposed "leeway investment" authority. Unlike commercial banks, however, thrift institutions would be subject to a limit of 10 percent of assets in consumer loans. It seems hardly likely, under these circumstances, that all deposit institutions would have the same ability to respond in the face of rapid increases in the rate demands of their depositors. Those that could not meet the highest rates offered by competitors in the same market might well experience precisely the disintermediation, liquidity strains and loss of lendable funds that the removal of deposit rate ceilings was intended to avoid.

Ways of Acquiring Lendable Funds

Besides freeing up rate competition for deposits, the Commission has proposed greater latitude for all deposit institutions as to the ways in which they can acquire lendable funds. Deposit thrift institutions would be allowed to offer a wider variety of deposit accounts varying with respect to maturity and withdrawal power as well as rate – a power commercial banks already have subject to rate ceilings. Presumably, the highest rates of interest would be reserved for deposit accounts of the longest maturity and the most restrictive withdrawal provisions. Thus, an institution whose earnings or surplus position might not be conducive to paying a competitive rate on all its accounts uniformly would then have the option of paying such a rate to depositors willing to take some risks as to market levels during the term of the account and upon maturity. This effort to segment the deposit base and lengthen average maturities has been helpful, in states where it is now allowed, in matching increases in interest expense with increases in current earnings and has served to hold existing deposits that might otherwise have been attracted to other investments. The experience to date, of course, is not a clear indication of things to come, because deposit rate ceilings were applicable. But even if a larger percentage of total deposits moves more quickly into such accounts in the future, the rise in interest expense should be more gradual than it would be if all accounts had to receive the market rate, and liquidity strains should be diminished by longer average maturities. This process should smooth considerably the flow of funds into all deposit institutions.[2]

[2]Commercial banks would have some additional capabilities for acquiring lendable funds during the initial five-year period when differentials in deposit rate ceilings could still exist between different types of institutions depending on whether or not third party payments were being made. Thus, they could incur non-deposit liabilities through temporary or contingent sales of assets and not have them classified as deposits subject to the rate ceilings. Similarly they could create bankers' acceptances without being subject to a statutory limit based on capital (although possibly still subject to administrative limits). Both proposals reflect the view, as does the basic proposal to abolish deposit rate ceilings, that policies of monetary restraint can be more effectively implemented by means other than deposit rate ceilings broadly applied – a view most economists seem to share. Commercial banks and thrift institutions would also be free to issue short-term subordinated debt instruments as well as the seven-year instruments currently authorized, so long as they were bona fide additions to capital. As a practical matter, only the largest institutions might be able to market these noninsured capital instruments if regular deposit accounts were also competitively available at market rates. The Commission is unclear as to whether such short-term instruments could be offered before, or only after, deposit rate ceilings are removed. If before, their offering to depositors could easily subvert the ceilings still in force.

Asset Diversification Proposals

Most of the Commission's asset diversification proposals can be supported on grounds either of increased competition or of increased public convenience, whatever problems they may otherwise present. Consumer credit markets, for example, are demonstratively imperfect resulting in higher than necessary rates for many borrowers. Permitting mutual savings banks and savings and loan associations to make consumer loans would markedly increase the number of credit sources available to borrowers, and the increased competition sure to result would encourage the lowest possible interest costs consistent with efficient operation. Permitting such institutions to make construction loans in the same manner as commercial banks or to make loans on mobile homes should have the same result as well as benefiting the housing markets they presently serve. A limited "leeway investment" power could benefit some borrowers by permitting loans to perfectly creditworthy applicants whose collateral is unusual or not technically in compliance with the requirements of statutory or administrative policy. The management and sale of mutual funds, including commingled agency accounts, would broaden the financial services offered to bank customers and permit investment talent within offering banks to be more completely utilized – although even the largest banks may shy away from the risks of customer dissatisfaction in the event of unfavorable performance. Checking account services at thrift institutions would consititute another form of deposit competition and might serve as a convenience for some thrift institution customers who do not utilize commercial banks. To the extent these services attract or retain deposit customers, the stability of deposit structures should be smoother than might otherwise be the case.

Some Reservations

I would be remiss, however, if I failed to indicate my reservations with regard to some of the Commission's asset recommendations that would introduce a far greater degree of risk into the financial structure than we have today. Those that could have serious repercussions on safety and soundness, at least in the form proposed by the Commission, include the following:

1. *The power to make direct investments in real estate.* The Commission states this recommendation in terms of a limitation equal, in most cases, to 30 percent of an institu-

tion's net worth, but a close examination of other recommendations would indicate that the limitation is illusory. For example, additional investments up to another 30 percent of net worth would appear to be authorized under the "leeway" investment provisions. And it would appear that no limitations would be imposed upon the investments a thrift institution or a commercial bank could make in a subsidiary which engaged in real estate development or ownership. Because real estate can fluctuate significantly in value and is one of the most difficult assets to sell if liquidity is needed, the potential for loss has historically been considered greater than for many other investments. An effective limitation substantially less than 100 percent of net worth should apply to all direct investments in real estate, including bank premises, regardless of the form of the investment.

2. *The power in deposit thrift institutions to invest up to 100 percent of net worth in equity securities listed on a national exchange.* While mutual savings banks in some states today have a similar power, and state-chartered commercial banks not members of the Federal Reserve System in some states may also own equity securities for their own account, the pressures to maximize profits will, as we have seen, be greater in a world without deposit rate ceilings than they are today. In addition to normal risks of loss in stock market investments, these pressures may encourage undue speculation in order to gain an edge over competitors or to overcome the edge of other institutions. The exposure of an institution's capital funds should be significantly less than 100 percent in my judgment, even if the basic recommendation is retained.
3. *The power to engage directly in nonbank activities presently being authorized for bank holding companies by the Federal Reserve Board.* The objections to a general grant of authority along these lines, on the grounds of safety and soundness, are well stated by Dr. Chase in his paper, although undoubtedly some activities being authorized by the Board of Governors for bank holding companies could be carried out by deposit institutions directly without significant increase in the risk to which they are presently subject. To those who say that the

> Commission's recommendation contemplates a review by the Administrator of National Banks for national banks, the Administrator of State Banks for state banks, and the Federal Home Loan Bank Board for savings and loan associations before such authority is granted, I think the clear expectation of the Commission had to be that all the activities being authorized for bank holding companies by the Board of Governors would be authorized for direct operation by deposit institutions. There are clear exhortations for a liberal interpretation of the Bank Holding Company Act Amendments of 1970 and the divided review contemplated by the Commission almost guarantees this.[3]

With these exceptions, the Commission's recommendations for expanded asset powers are likely to increase competition and public convenience without substantial increase in risk to the financial structure as a whole. They should also assist deposit institutions in maximizing earnings, while the Commission's liability proposals should smooth out the peaks and valleys in the flow of funds to such institutions. But I think it overstates the effect of these recommendations to claim for them as well an inevitable, beneficial effect on credit flows to residential housing in future periods of tight money. At best such an effect can only be indirect – through increased earnings, through the ability thereby to pay competitive market rates on deposits, and through increasingly stable and predictable deposit flows. Even under such circumstances, a net plus for housing would

[3]To the extent the three agencies differ in their authorizations under this recommendation in any competitively meaningful way, there would be every incentive to convert to the jurisdiction of the most lenient supervisor. At least two different ways of administering the provision would avoid that result:

(i) the Federal Reserve Board itself could be assigned the job of determining which of the related activities being authorized for bank holding companies might properly be conducted directly by deposit institutions or their subsidiaries, and under what conditions; or

(ii) Congress could enact a "positive" laundry list of related activities authorized to be performed directly by supervised institutions, prescribing any necessary conditions by statute, and supplementing the provisions periodically.

Obviously the first alternative has advantages in terms of flexibility and is the only one which assures that the same criteria being applied by the Federal Reserve Board in determining the approved activities of bank holding companies will also be applied in determining the activities to be authorized for direct operation by banks and their subsidiaries.

be felt only if institutional managements were determined to commit new funds to residential housing in such proportions that the total would approximately equal the percentage of total assets presently invested by all deposit institutions.

My doubts that this will be the case stem from the fact that there appears to be only an inverse correlation today between the degree of diversification permitted to an institution and its commitment to the residential housing sector. The average commercial bank, with the broadest capacity to diversify loans and investments, devotes a far smaller percentage of its total assets to residential mortgage loans than the average savings bank, and the latter, which has significant but limited opportunities to diversify its loans and investments, devotes a significantly smaller percentage of its total assets to such loans than the average savings and loan association – the institutional type with the least opportunity to diversify at the present time. Of the three, the $200 billion savings and loan industry, at least in recent years, has been the principal supplier of funds to the residential housing sector, both in dollar volume and as a percentage of total assets.

Those of us from New England and New York, where the $90 billion in the mutual savings bank system is concentrated, tend to overlook the relatively greater contribution and commitment made by savings and loan associations to the residential housing market. Since many savings banks in these states already have the power to make nonresidential mortgage loans on commercial property, consumer loans up to some limited percentage of assets, investments without limit in corporate or municipal debt obligations, and limited investments in common stocks or leeway investments, and since they still invest on the average 59 percent of their total assets in residential mortgage loans, we tend to assume that the added powers proposed by the Commission will not have any perceptible effect on the flow of funds to residential housing. Yet the same proposals also apply to the nation's savings and loan associations that presently invest about 85 percent of their assets in residential housing. If that much larger industry, in utilizing the same powers under the same competitive conditions, were to reduce the percentage of its total assets committed to residential housing to the same 59 percent of assets presently invested by the savings bank industry – even if this occurred gradually over time – the effect on the residential housing sector could be noticeably adverse despite improved flows of funds.

To its credit, the Commission appears to have recognized this problem by suggesting in its new scheme of things a direct government incentive, either by way of tax credit or direct subsidy, which would maintain present high levels of investment in residential housing; but the details of any such incentive have not yet been spelled out and it would appear impossible for observers at this stage of the game to speak with authority on the impact which implementation of the Commission's recommendations would have on the funds available for residential housing. The most that can be said is that if present levels of investment are maintained by deposit institutions throughout the nation, residential housing should not suffer and might indeed benefit from the more even flow of funds which the Commission's recommendations on the liability side are designed to encourage. But this would seem to me to be a big "if" until the magnitude and relative attractiveness of the incentives to be proposed becomes known.

DISCUSSION

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Since I received Mr. Wille's paper very late in the game, and find myself in substantial agreement with it in any case, I would like to offer some independent and rather general comments on several aspects of financial, and particularly bank, diversification. My frame of reference will not be marginal additions to the list of assets that may be acquired or liabilities that may be issued, but rather the more substantial extensions of function, frequently by a proliferation of corporate entities within an increasingly complex structure, such as are at stake in the Bank Holding Company legislation of 1970 and in the recent spate of bank-sponsored real estate investment trusts. I hope to focus, if only briefly, and provocatively, on some neglected – and sometimes anticompetitive – facets of recent diversification decisions and trends. I have put them in the form of eight notes or points of comment.

Proper Scope of Financial Institutions

1. There is no scientific basis for decisions as to the proper scope or rate of diversification of financial institutions. It is a debatable point as to whether a reasonably scientific judgment could be made concerning, say, the effects on competition alone of bank diversification into mortgage banking, especially long-term and potential effects. (See further, points 4 and 5 below.) But it is clearly beyond the capacity of science to weigh in the additional effects of diversification on efficiency, customer convenience, potential conflicts of interest, and the social and political impacts of such structural change. In principle, but not in fact, probable consequences could be estimated for each of these variables; but weighing them in order to arrive at a policy finding is beyond science even as a matter of principle.

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Legislative Instructions to Regulatory Bodies

2. Legislatures nontheless establish "laundry lists," or instruct regulatory bodies such as the Board of Governors of the Federal Reserve System to establish diversification limits on the basis of certain stipulated factors. On what basis do these bodies arrive at their conclusions if science offers too little in the way of sustenance? This brings us quickly into the sphere of politics and value systems, which supplement, if they do not overwhelm, technical economics – these three are blended together in complex ways to yield a decision, which is sometimes a true witches brew. The ingredients of the brew include: (a) the particular values, preferences, economic theories, ideologies, and personal influence of the individual regulators; (b) the political climate of opinion and distribution of political power, which determine both the choice of regulators and the economic issues thought to be relevant[1]; (c) the strength and energy of the contesting parties, measured in part by their capacity to lobby, litigate, and ultimately bargain for their right to compete or to avoid certain forms of competition[2]; (d) the degree of past encroachment into an area, or accumulated vested interest – if the diversifying institution is already a significant occupant of a turf, there is a strong propensity to find it "closely related" as a matter of *fait accompli*. It would be very surprising to find a regulatory body declaring an activity to be not "closely related," and ordering its disassociation, where substantial penetration had already occurred.

Celerity of Regulatory Action

3. The influence of political and power considerations in regulatory decision-making processes is sometimes reflected in the

[1]For example, safety and the avoidance of conflict of interest in the 1930s; competition in the more buoyant 1970s.

[2]For example, in contrast with some larger and better financed industry groups, the association of businessmen in the computer software field has suffered from a limited financial capacity to litigate against policies of the Comptroller, or to prepare adequately for hearings or to appeal unfavorable decisions by the Board of Governors. This may well influence the extent to which banks will be able to enter their field. Another example may be found in the investment company area, where the relatively greater ability of banks to form real estate investment trusts, as opposed to investment companies dealing in ordinary stocks and bonds, can be explained to a great extent as a function of the relative political weight of pre-existing occupants of the field.

In brief, the ability of "related businesses" to prevent competitive entry into their turf tends to be a positive function of their power (which is probably correlated with the social need for such entry).

celerity of regulatory action. The regulated industry may be eager to expand and the pressures which it exerts on the authorities to make rapid decisions are then intense. The only thing that should constrain a regulatory body from rendering quick decisions is that the substantive issues are often extremely complex, and the long-term effects of such decisions tend to be essentially irreversible and permanent. One would assume that serious investigations and research, plus extensive and careful deliberations, would be very much in order and would take considerable time – a minimum of say two years. When the lag between legislation and regulatory decision is shorter – much shorter – a question must be raised whether the decision is based on a solid groundwork of fact, analysis, and reflection.

Effects of Diversification on Competition

4. There is a curious tendency observable in the Hunt Commission report, in Board decisions, and elsewhere, to assume that diversification by entry into closely related fields, even via merger, is procompetitive, or at worse neutral in effect. One deficiency in this view is that it rests on an unduly narrow time horizon. If General Motors enters the fields of bus or locomotive engine manufacture, the short-run effect will very likely be to enhance competition; the long-run effect of the presence of such a powerful force in a market is, at a minimum, much more obscure.[3] Even *de novo* entry, which will very likely be procompetitive or neutral in the short run, may in the long run have no positive competitive benefit to offset what may be regarded as an adverse social impact. (It may even have a negative competitive effect in the long run.) Where decisions are being made that are likely to be irreversible and very possibly cumulative in character, exclusive emphasis on short-term effects would seem singularly inappropriate.

Effects of a "Close Relationship" on Competition

5. Antitrust standards are violated by employing the concept of "closely related" as a major consideration favoring an application for merger or even *de novo* entry. If another business is "closely

[3]Its competitive power may permit it to establish a kind of limited hegemony, and at the same time to raise barriers to new entry. This may facilitate a better organization of the market, a system of mutual forebearance on sensitive behavior variables (e.g., price), and a more effective defense of the industry in the public and political arenas.

related," this suggests: (a) some degree of existing competition where the products are substitutes;[4] (b) the possibility of potential competition at some future date; and (c) an environment strongly conducive to the development of tie-ins. Since these considerations unfavorable to competition are extremely difficult to measure *ex ante,* the standard in question involves a major built-in bias favorable to the rapid growth of conglomerate financial power centers,[5] contrary to antitrust principles.

Parenthetically, it may be noted that although the Hunt Commission Report and policy perspective are oriented toward improving the financial system via stimulating competition, very little attention is paid in the Report to the anti-competitive aspects of some of the recent laws, rulings, and trends that have facilitated the surge toward financial conglomeration. I also fail to see in the Report any recognition of the fact that existing structural conditions may be detrimental to competition – for example, the extensive interlocking relationships between savings banks, savings and loan associations, insurance companies, and commercial banks – and may require remedial action. Phillips and Jacobs tell us in their paper that political realities led to recommendations "designed with the goal of not imposing competitive costs in excess of the value of competitive benefits conferred, on any broad segment of the deposit intermediaries." Breaking down pre-existing structural obstacles to competition which operate across the spectrum of major institutions would not meet the political realities suggested by this statement – it would confer benefits only on the consumer!

Effects on Integrity of the Regulatory Process

6. Where diversification is permitted in industries that are publicly insured and regulated, the effect of diversification on the integrity of

[4]If expansion into "closely related" businesses were consistently restricted to markets not presently occupied by the expanding firm, these strictures would have to be qualified, but no such consistent limitation is evident in the decisions of the Board of Governors. See, for example, "First Chicago Corporation, Chicago, Illinois, Order Approving Acquisition of I. J. Markin & Co.," *Federal Reserve Bulletin,* Feb. 1972, pp. 175-177; "First Bank System, Inc., Minneapolis, Minnesota, Order Approving Acquisition of IDS Credit Corporation," *Federal Reserve Bulletin,* Feb. 1972, pp. 172-175; "First National Holding Corp., Atlanta, Georgia, Order Approving Acquisition of Dixie Finance Company," *Federal Reserve Bulletin,* May 1972, pp. 503-504.

[5]Since each step in the accretion process shifts the margin of institutional interest outward, we may assume that new frontiers of "closely related" fields will continue to open up and be occupied.

the regulatory process is a relevant consideration. Diversification may affect the capacity of regulators to audit, to see that law is adhered to, and to keep potential conflicts of interest under reasonable control. Such matters do not seem to have been given much weight in recent legislative and regulatory developments, or in the Hunt Commission Report. My own investigations of the commercial banking business and the savings and loan industry suggest to me that examination and supervision invariably lag in coping with changes in industry scope and practice – with the severity of the lag closely related to the speed and extent of the changes, the complexity of the organizational structures developed, and the severity of the conflicts of interest which are built into those structures. Frequently, inadequate funds and limited legal powers to investigate compromise supervision, and result in the institutionalization of a rote type of examination that is incapable of coming to grips with serious problems. The industry also may lobby and bargain to protect itself from serious supervision. One effect of all this may be an increase in problem cases; but far more important is the potential weakening of the entire fabric of the industry which may result from token regulation, rendering it more sensitive to adverse external changes.

Effects on Conflicts of Interest

7. The regulatory process is ill-suited to cope with severe, built-in conflicts of interest. An examiner can hardly police the distribution of new mortgages as between a bank mortgage portfolio and that of a managed and controlled real estate investment trust. There is also very little that examining authorities can do to prevent tie-ins that are not recorded on printed forms or in writing (and few of them are so recorded). The Hunt Commission recommendations with respect to bank trust departments also impose an unrealistic burden on the regulatory process – the idea that examiners are capable of determining that trust department brokerage is used for best executions, and is not used at all to buy deposits, is, I believe, quite unreasonable.[6] These burdens are imposed on regulators because of

[6] Similarly, the Hunt Commission's recommendations that the trust departments of the larger trust banks "deny trust department investment personnel access to commercial banking department credit information," and that "no director, officer or employee of a corporate fiduciary recommends or initiates any purchase or sale of securities on the basis of insider information," gets at the problem of inside information in banks in a manner reminiscent of King Canute's method for handling an objectionable incoming tide. See further, Edward S. Herman and Carl F. Safanda, "The Commercial Bank Trust Department and the 'Wall'," *Boston College Industrial and Commercial Law Review,* Vol. 14 (forthcoming).

an unwillingness or inability to create or to recommend structures free from serious conflict of interest. They are inherently tokenistic, a gesture in the direction of virtue where the real solutions are thought to be impractical for political or other reasons.

Effects of Interest Payments on Demand Deposits

8. There is a widely held view that an inappropriate degree of diversification is a result, in part, of the legal prohibition of the payment of interest on demand deposits. This prohibition, it is argued, enhances the profitability of demand deposits, and thus induces banks to add and subsidize services, like pension fund management, that will help pull these deposits in. The conclusion drawn is that elimination of the prohibition on interest payments would eliminate the profit margin that induces the unwarranted additional services.

This theory contains a germ of truth, but that germ is insufficient to sustain the inference about diversification, or the policy conclusion. It rests on the implicit assumption that perfect competition would exist in the market for demand deposits in the absence of the prohibition; otherwise, a favorable profit margin conducive to subsidized diversificaiton should continue to exist. If the margin were reduced, however, wouldn't the inducement diminish? The answer is that this is by no means obvious. The banks might push into outside activities even more aggressively in order to compensate for the reduced profit margin. The rush of the larger banks into bank holding companies, and into the non-banking activities permitted those organizations, has often been explained as a consequence of the pressure of the rising costs of time money[7] – which suggests that the effect of the abandonment of the prohibition of demand deposit interest payments might be exactly the opposite of the proposed in the hypothesis under consideration.

There are other objections to this hypothesis that I can only mention in passing here. One is its tendency to neglect the complexity of the customer relationship, which makes a tie-in effect and the marketing of a "full line" advantageous on the basis of the profit to be derived from a variety of services. A second weakness is in the assumption that the peripheral services are necessarily

[7]For example, see John R. Bunting, Jr., "One-Bank Holding Companies: A Banker's View," *Harvard Business Review*, May-June 1969, p. 100.

unprofitable, or need remain so in the long run. A third is its failure to take into account changes that have reduced or extinguished the surpluses formerly more conspicuous in corporate demand deposit balances – especially the improvements in business cash management and the availability of a wide array of money market instruments for the investment of surplus funds beyond those needed to compensate the bank for desired services.[8]

Finally, the hypothesized effect of the freeing of competition on the profitability of demand deposits, and on the willingness of banks to diversify and to subsidize peripheral services, is not supported by the historical record of the era prior to the Banking Act of 1933. In the 1920s and earlier competition never succeeded in reducing profit margins on demand deposits to a point causing banks to lose interest in them or to slow down the long and steady process of bank diversification.[9] Complaints about trust department (and other service department) subsidization and unprofitability in the interests of the commercial arm were as common before 1930 as after.[10] The trust company movement and the integration of trust companies into national banks were major developments of the period before the Act of 1933. It may be argued that institutional changes, including the activation of antitrust in the financial sector, make competition potentially more acute today than before 1930, but this is debatable.

[8]On the assumption of unrestricted competition in the market for demand deposits – except for the prohibition of interest payments – corporate customers should obtain full value for any demand deposit surpluses in their purchases of ordinary services, including lines of credit. It is easy to construct a model conforming to these assumptions in which there would be no advantage to the banks arising out of the prohibition, and no surpluses that would induce any non-price competition.

[9]See Albert H. Cox, Jr., *Regulation of Interest Rates on Bank Deposits,* University of Michigan, 1966, Chaps. 1-2.

[10]In the mid-twenties, for example, it was a common view "that in many instances the trust department was very frankly organized simply as a service department and that it was not the intention to put it on a sound profit and loss basis, the theory being that the expenses of the department would be more than compensated for by further strengthening the relation of the customer with various other divisions of the commercial bank." (John C. Mechem, "Trust Department Earnings: Adequate Fees and Practical Systems of Cost Accounting and Allocation," *Trust Companies,* October 1926, p. 400.) An unsigned editorial in the same journal said: "Even allowing for the patient novitiate stage it is no secret that many trust departments are operated at a loss. Numerous trust companies and banks justify trust departments mainly as 'feeders' or as adjuncts to other departments for competitive reasons. A large volume of trust assets is in fact a liability. There are not a few trust departments which have have been established for a sufficient number of years to justify expectations of profit which are barely self-sustaining." (*Trust Companies,* July, 1925, p. 128.)

It should be remembered that it was during the early 1930s and after that the banks were able to develop and sustain a "prime rate convention" that is hard to reconcile with the notion of unrestricted competition in banking.

Competition in the financial sector should be encouraged, by all means. But it should be encouraged within a framework of some conception of a desired market structure toward which we wish to move, and a reasoned belief that the growth and integration processes now under way are carrying us in that direction. Furthermore, it would be a mistake to assume that most financial markets ever came close to conforming with the competitive model, or that they could be brought very much closer to that ideal without a truly radical reconstruction of the financial structure. It would be an even greater error to assume that marginal steps toward competition, or even substantial movements in that direction, will not create their own complications, and that they are the philosopher's stone that will solve the problems which our financial system is finding so intractable.

DISCUSSION

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Chairman Wille's paper discusses three fundamental features of the Commission report. These are:

1. The relative priorities given the social goal of competition versus maintenance of traditional regulatory arrangements.
2. The relationship between competition in the markets for funds on the one hand and the markets for assets on the other. Especially important here are the impacts of changes in competition in one set of markets on the other set of markets.
3. The implication of the Commission's recommendations for structural change on the risk exposure of financial institutions.

More Competition Versus Established Regulatory Arrangements

The Commission did not try to maximize competition in the financial sector by sweeping away all the many and long-standing constraints on competition. The Commission's goal of defining politically feasible recommendations precluded such an objective. Nonetheless, as Chairman Wille points out, the Commission did place its priority on obtaining more competition rather than on minimizing the adjustments to the structure of the financial regulatory mechanism that has been developed over the years. Given this priority, as Chairman Wille stated, few of the Commission's recommendations come as a great surprise.

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The Commission apparently adopted its viewpoint because of three considerations. First, regulation creates inequalities in periods of monetary restraint. Second, increased competition would help eliminate inefficiencies in the financial sector. Third, more competition would make response to technological change easier.

I share this viewpoint and believe Chairman Wille concurs. Nonetheless, it goes counter to the spirit of many other attempts to improve our financial structure and the structure of regulation within which competition takes place. Traditionally, reform has aimed at creating or encouraging specialized institutions to meet new or specialized needs rather than depending upon existing institutions to expand into new areas or into areas not now well served. Moreover, instead of encouraging diversity in regulation, the usual goal of reformers has been to try to centralize and coordinate financial regulation.

Mr. Barr's paper makes the case for the traditional approach, so little more need be said here about the basic philosophical approach. Instead, let us continue with the two other points that I cited earlier. These raise operational questions about implementing the Commission's recommendations.

The Link Between Fund Markets and Asset Markets

Chairman Wille questions the parity between the Commission's treatment of competition in the markets in which financial institutions obtain funds and competition in the markets in which they provide services or acquire assets. Financial institutions are intermediaries. Much of the confusion about competition in the financial sector stems from failure to distinguish between the markets in which financial institutions obtain inputs and the markets in which they sell outputs. Financial institutions all seek funds and, as the 1960s demonstrated, depositors are willing and able to switch from institution to institution or type of institution to type of institution with impressive speed.

Asset markets and the markets for financial services other than deposits are less competitive. There are problems of oligopoly, credit standards, credit rationing, and the other structural and behavioristic characteristics that make it less easy for a customer to switch from institution to institution. Most important for the present discussion, institutions practice product differentiation by specializing in different types of assets.

The Commission would free up some of the constraints that in part cause this specialization. Nonetheless, Chairman Wille suggests that even if all the Commission's recommendations were implemented, more controls would remain over asset competition than over deposit competition. Put differently, the Commission would, in Chairman Wille's opinion, increase competition more on the liability side of the balance sheet than on the asset side. He would expect to see more specialization of assets than of deposits.

Chairman Wille is bothered by the logic and equity of this difference in treatment. It seems to me that this difference already exists and at worst the Commission's recommendations would merely heighten the competitive difference. It also seems to me that the Commission's treatment can be explained by its desire for feasible recommendations. Increasing competition in product or asset markets is harder than increasing competition in markets for funds and it is not surprising that the report reflects this difference.

Chairman Wille also suggests that asset specialization combined with more competition for deposits would create problems of disintermediation, illiquidity, and the other difficulties encountered in the 1960s. He argues that institutions will have to respond faster to changes in the supply or price of deposits. Institutions with liquid assets will be in a position to respond faster than those specializing in long-term assets.

What does this imply for public policy? It is hard to see that maintaining Regulation Q and like controls is a superior alternative to the Commission's recommendation merely because some institutions will find it easier than others to respond to heightened competition for deposits. The important point, in my opinion, is that increased competition in fund markets will not insure against disintermediation and liquidity problems. It is unlikely that all institutions will be in the same position with respect to the liquidity of their assets, and they will differ in their abilities to structure their portfolios as they might wish to do in the absence of regulation.

Risk Exposure

Three Commission regulations would, according to Chairman Wille, increase the risk exposure of financial institutions. These are the recommendations relating to:

1. Direct investment in real estate
2. Equity investments by thrift institutions

3. Increased authority for banks to engage in activities now permitted holding companies.

These may be the direct impacts but I think that if the Commission's recommendations were implemented there would be a general increase in risk exposure due to a heightened likelihood that any firm's market might be invaded by another institution and other increased competitive pressures.

A competitive environment implies failure of firms. In general, financial regulation has sought to minimize the rate of failure of financial institutions. We need not debate the wisdom of this policy. The important point here is that it is a key feature of the current regulatory system. Financial entrepreneurs can assume relatively low rates of failure and can assume regulatory action to make this happen. The report deals with the mechanics of deposit insurance but it did not really deal with the question as to the extent to which we should permit the rate of failure to increase in order to obtain more competition, or how to imbed this policy in operational rules such as examination standards.

I would enjoy hearing Chairman Wille discuss the extent to which we should permit more failures and how we should respond to failures. The Commission report rejects the notion of variable insurance rates. I understand the objections but am still concerned about the result of uniform rates in an environment with more competitive risk. The cautious institutions will be paying for the bold, adventurous firms with the higher failure rates. I don't know the answer to this problem but believe that if the Commission recommendations are implemented insurance and failure rates will become more important policy issues than they are at present.

I am totally in agreement with a policy that would reverse the thrust of regulatory policy so that success will no longer be measured as the inverse of the number of institutions that fail. I wonder, nonetheless, about the resulting operational problems, specifically:

1. Are insurance funds sufficiently adequate to cope with the new environment?
2. How many failures can we have before we encounter systemic failures?
3. Will bankers, S&L officials and other financial officials really believe that the government will let them fail? Or will they assume that the federal agencies will bail them out and make their decisions on this basis?

4. Will the federal authorities bail out financial failures? Put differently: How many failures will the regulators allow before they step in?

I don't know the answers to these questions but I wish that the Commission or Chairman Wille had answered them. The point I want to make is that if we are going to talk about policies for more competition, we have to talk about policies toward liquidity and capital problems of firms. These are two sides of the same coin.