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Remarks to
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THE ILLUSION OF INTRASTATE BANKING

Stephen J. Friedman, Commissioner

I am pleased to have an opportunity to participate in this discussion about the future shape of our financial markets and the role of government regulation in the process of change. I have been on both sides of the issue of regulation in the financial markets. At the Treasury, I spent a good deal of time on what ultimately became the Depository Institutions Deregulation and Monetary Control Act and on the early stages of the Carter Administration's interstate banking study -- both significant steps in the direction of deregulation. At the SEC, my primary function is to administer a regulatory system.

This meeting is part of a great national debate that will determine the future of our financial markets. This is a time of challenge, excitement and their inevitable handmaiden, anxiety. The debate proceeds on a high plane: the values of competition, of diversified financial services and of free market forces on the one hand, and the virtues of housing credit, community banking services and multiple providers of capital on the other. The values that are being weighed on both sides of the balance are important. But make no mistake. The facts underneath the high plane of the debate have changed radically. Accordingly, the debate does not bear on whether we should maintain the <u>status quo</u> of the financial markets reflected in the regulatory apparatus put in place in the 1920's and 1930's. That world is already gone.

I would place before you three principles which I think should guide this debate:

-- the forces that have worked such radical change in the world in which bankers operate -- principally inflation and technological advances -- will not go away (and in the case of inflation, will not be fully controlled in a time frame that permits bankers to cling to the old ways).

-- many of the changes that have been resisted as a matter of law have already occurred as a matter of fact.

-- the regulatory power of government in a large and complex economy is quite limited. It functions within the ground rules fixed by basic economic forces.

<u>Forces for Change</u>

The two major forces for change in the financial markets are inflation and technology. One need only look at the savings industry to see the enormous impact of those forces, an impact

that occurred without heed for the great debate then going on (which still continues) about the need for mortgage credit and the importance of protecting savings institutions.

To be sure, inflation does not bear the same relationship to interstate banking that it does to deposit interest rate controls. But it is inflation that has produced the real threat to the world envisioned by the McFadden Act: a horde of competitors for the deposit dollar that are not subject to the barriers to interstate activities -- for example money market funds, broker-dealers and even issuers of commercial paper to individual investors. So long as inflation persists, the pressures on capital users to seek new forms of access to capital, giving rise to new intermediaries, will continue.

If I were to ask the people in this room to name the three industries which will show the greatest growth and have the most impact on American lives over the next 10-20 years, I have no doubt that information processing and communication would be on virtually everyone's list. We have a national economy -- and an increasingly international one. We have national and increasingly international capital markets. Communications technology provides the sinews for that powerful economy, and creates momentum for its use.

These trends will not disappear. They will intensify. And their impact on interstate banking is perfectly obvious. It is obvious because the effects of these pressures are already all around us.

<u>The Reality of Interstate Banking</u>

I submit to you that anyone who examines the financial landscape with clear eyes must ask whether the reality of interstate banking has not by-passed the debate about interstate banking. Banks are intermediaries. They take deposits and use those deposits to make loans. So do many other financial intermediaries. In theory, banks and savings institutions are the only intermediaries that do so confined within state (and sometimes more narrow) borders. But on closer examination, even banks are not significantly confined to local boundaries.

Reflect for a moment on deposit-taking. Money market funds, brokerage firms holding free credit balances, pension fund managers and investment advisers -- all of which compete for individual and corporate savings -- operate on a nationwide basis. To the extent that money market funds perform a commingling function for small account holders and purchase large CD's issued by banks, those banks are accepting deposits indirectly from all over the country. The competition for wholesale deposits is of course nationwide, and corporate demand deposits that are an adjunct of broader banking relationships are not confined to state boundaries. Recently three major New York banks have begun campaigns

to seek consumer deposits throughout the country. And the union of American Express and Shearson has enormous potential for innovation in this direction.

The interstate activities of banks on the lending side are even more dramatic. The combination of credit card lending and bank-owned finance and mortgage banking companies represents a substantial penetration of the consumer loan market throughout the country. Wholesale lending is part and parcel of the international capital market, and in the case of Edge Act companies, it even takes the form of out-of-state brick and mortar branches.

What is left of the prohibition on interstate banking? Not much. Of course, that does not mean that there is not much left of intrastate banking. We have 15,000 commercial banks in this country, and all but a relative few are largely local enterprises. Is the McFadden Act all that stands between those bankers and extinction? Will we end up with ten large banks blanketing the country? And if that is where we are headed, could the government stop the trend if it were desirable to do so?

The Limits of Government Intervention

In my view, it is neither wise nor possible to try to put the Humpty Dumpty of intrastate banking together again, even recognizing that some consolidation would take place in the existing group of banks. It is clear that the advantages of large, multi-service banks are quite different from the advantages of community banks. Each has its place, and depositors should too be permitted to choose.

The experience of states, like New York, which have liberalized their branching laws suggests that, in our highly diverse society, many depositors will prefer the personalized service and understanding offered by a community bank. If that is so -- and I believe it is -- then many smaller banks will continue to prosper. On the other hand, many depositors have already voted on this issue with their feet. They have placed their savings with money market funds or unregulated intermediaries because the interest rates or other services offered by their local banks are not as attractive. That competition is healthy, and the law should not be used to deprive depositors of the option of electing to use the services of a large bank. Moreover, the effect of unit-banking and similar laws in some states has been to create and support real local monopolies in some areas, a very unhealthy state of affairs.

There are analogues to this debate in the discussion preceding the authorization of NOW accounts. There was much discussion of whether the inevitable disappearance of "free" checking would be bad for the small depositor. One consumer advocate

testified that "it would be an act of lobbying magic if the banks convinced us that it would be bad for us for banks to pay interest on demand deposits." In the same way, there is a bit of sleight of hand in the argument that depositors in small- and medium-sized towns are better off if they are deprived of the right to choose a large, moneycenter bank as an alternative.

Moreover, the power of government to curtail severely the level of interstate bank and bank-like services is rather low. Interstate wholesale banking activities have grown in response to demand from American business. Then consumer demand in the 1970's saw a similar growth in interstate retail operations. If those interstate operations are restricted, the demand will not disappear. It will be met by new unregulated lenders and deposit-takers. Money market funds, interstate credit card lending and the securities industry's cash management accounts are only today's Loch Ness monsters for banking. More are lurking under the water.

Moreover, internationalization also curtails the regulator's power to limit interstate activities. The spectacle of large foreign banks acquiring substantial banks in this country under circumstances in which no large American bank is permitted to compete for the acquisition is not tolerable over the long run, even for people who do not object to foreign acquisitions of U.S. banks.

The Future

If I am correct, and the direction of change is irreversible, where do we go from here? First, it is important to think separately about the short run. Permitting American institutions to make interstate acquisitions of failing banks and savings institutions deserves immediate attention. Second, we must confront the issue of new branches vs. acquisitions. If there is a lack of banking competition in some areas, the depositor would be better served by encouraging the establishment of new branches rather than acquisitions of existing banks. But an interstate banking policy that provides new out-of-state competition for community banks (or even large regional banks) but denies them the ability to sell their bank if they cannot survive would be very harsh indeed. It was that concern that led the Carter Administration to suggest a phased elimination of the Douglas Amendment, together with freedom to establish out-of-state electronic banking terminals. I think that is a sensible way to start to conform the legal structure to reality.

The impact of these changes on the banking industry is a highly sensitive issue. Like the debates about Regulation Q and the Glass-Steagall Act, this question raises sharply the question of the role of large banks in this country, and opponents of change raise the spectre of an economy dominated by a

few banks. I do not agree with that picture of the future. The available evidence suggests that smaller institutions, both regional and community banks, have an important role to play and that the markets will continue to recognize that role. Moreover, the bank regulators can and should be given the power to control the nature of acquisitions. For example, during a transition period, the larger regional banks might be made immune to take-overs.

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It should be clear that in my view this debate is not really about whether interstate banking should take place, but how it should take place. Unless the difficult questions of that transition are faced squarely -- and soon -- then policymakers will not have an opportunity to help shape this revolution. It will be over.