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# Books Reviewed

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## BOOKS REVIEWED

BANKING DEREGULATION AND THE NEW COMPETITION IN FINANCIAL SERVICES. By S. Kerry Cooper and Donald R. Fraser. Cambridge, Mass.: Ballinger Publishing Co., 1984. Pp. xvii, 278.

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Not long ago, consumers regarded banks much like utilities. Like electric and telephone companies, banks purveyed narrow lines of essentially similar products. The customer had the choice of any kind of financial product, so long as it was a passbook savings account or a noninterest-bearing checking account. Frequently, as with other utilities, there was little or no choice among providers, especially in rural areas. In those days, banks were the primary providers of credit to consumers and businesses and offered them a modest return for the safekeeping of their money.[1]

Times have changed. Today, the banking consumer faces a market crowded with a bewildering variety of financial products and providers. The contemporary bank may be a computer in a supermarket kiosk or even an 800 number, rather than a bricks-and-mortar office on the town square. Today's bank customer may have cashed in his passbook for a money market account, and his Christmas club for an IRA. In addition, he may buy his stocks from his bank—or, for that matter, the local Sears outlet.[2] These changes are national in scope, and have become a daily part of our decision-making in a way our grandparents never knew. Together, these changes make our traditional view of the neighborhood banker as quaint—and unrealistic—as a Norman Rockwell painting.

These changes have not occurred painlessly. Hundreds of banks have failed in recent years, and the pace is accelerating.[3] They are the

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1. S. COOPER & D. FRASER, BANKING DEREGULATION AND THE NEW COMPETITION IN FINANCIAL SERVICES 9 (1984) [hereinafter cited as BANKING DEREGULATON]. In 1960, banks were the only financial institutions offering checking account services and installment and business loans. *Id.* Today, however, these services are also provided by savings and loan associations, insurance companies and securities dealers. *Id.*

2. *Id.* at 11-14 (outlining the expanding scope of financial services offered by banks).

3. In 1986, 87 banks had failed as of August 11. *Banking: Failures Total 87, After Insolvencies In Four States,* DAILY REP. FOR EXECUTIVES (BNA) No. 154, at A-14 (Aug. 11, 1986). In 1985, there was a total of 120 bank failures. *Banking: Bank Failure Total in*

victims of many distresses: increased competition, bad loans in the energy, real estate or farm sectors, or simple fraud, depending on whom is questioned. In recent years, spectacular failures of state deposit insurance systems reminiscent of the Great Depression have deprived many depositors of their lives' savings. Local, community-oriented banks have merged with larger regional or even national institutions with motivations much different from the neighborhood banker's.[4] On a larger scale, the continued volatility of interest rates, the growing trade and budget deficits and the increased role of foreign finance in the American economy have convinced many that something is distinctly amiss with the nation's financial structure.

Cooper and Fraser have provided a useful guide through the thicket of these recent developments in the nation's financial system. Focusing on the changing role of depository institutions, *Banking Deregulation And The New Competition In Financial Services* provides a convincing, highly readable account of a decade of upheaval. Few works so neatly summarize the transformation of banking from a storefront operation to its current multinational dimensions. The particular usefulness of this work is its breadth—the authors incorporate discussions of the economics of regulation,[5] comparative banking structures among leading industrial nations[6] and significant regulatory changes.[7] The authors also offer important chapters on the interplay of deposit insurance and bank failures,[8] the changing structure of the financial services industry[9] and the outlook for the industry's future.[10] As a result, the book offers useful reference for the novice and thought-provoking analysis for the sophisticated.

The authors recognize that the wave of changes in banking result from several related phenomena: underlying economic forces, financial and organizational innovations, technological advances and regulatory change. Extremely high and volatile interest rates in the 1970's and 1980's set the stage for much of what followed. As the authors explain the familiar pattern, these exceptional rates forced both banks and their customers to change investment strategies.[11] As a result, customers demanded new products that could take advantage of these rates.

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*1985 Hits a Record 120, Thrift Failures Double*, DAILY REP. FOR EXECUTIVES (BNA) No. 2, at A-3 (Jan. 3, 1986). Contrast these statistics with only 17 failures in 1976. BANKING DEREGULATION, *supra* note 1, at 151.

4. BANKING DEREGULATION, *supra* note 1, at 226.
5. *Id.* at 34-41.
6. *Id.* at 71-90.
7. *Id.* at 105-24, 127-41.
8. *Id.* at 143-81.
9. *Id.* at 185-226.
10. *Id.* at 231-52.
11. *Id.* at 73.

Banks demanded new powers to diversify their asset base. These incentives were not missed by nonbank firms, which saw an opportunity to parlay their retail marketing skills and interstate networks into a newly created financial services industry. As the authors recognize, "the component of the economic system that has long been called the 'banking sector' is being supplanted by a *financial services industry* of which depository institutions are only a segment."[12]

At the same time, rapid developments led to the first major improvement in banking technology since the quill pen—electronic banking in all its forms. Automatic teller machines and experiments in home banking made the supply of banking services available upon demand anywhere at almost any time.[13] Electronic banking and other developments in data processing and telecommunications have made possible new products, lowered the delivery cost of services, and expanded the geographic market for every institution with access to a telephone. The ability of bankers and their competitors to deliver new services to consumers appears limited only by the consumers' willingness to learn how to use a modem. The prospect, ably visualized by the authors, of the demise of the teller line is alone sufficient reason to read this book.

Of course, many others have successfully described the tumult of change in the banking industry. Where these authors truly excel is in their application of economic analysis to describe these underlying forces. Throughout the book, the authors emphasize that the tumult in the banking industry results from and leads to new costs and benefits, and that bankers, competitors, customers and regulators all respond to these costs and incentives. Never hiding their pro-market, anti-regulation sentiments, the authors demonstrate how quickly this combination of forces changed the established order of the banking industry. As one small example, the authors examine the monopoly on demand deposits enjoyed until 1980 by commercial banks.[14] Due to prohibitions on payment of interest on such accounts, these banks competed solely on a nonprice basis with inefficiency and inequities resulting. With the availability of NOW-type accounts to most institutions following the first round of deregulation in the early 1980's, banks are forced to compete on price, slash costs and charge for some services. The authors make a good argument that such changes, while costly at first, will produce greater efficiency and equity eventually.[15] Analysis of this kind provides the reader with a firm understanding of the economic dynamics that drive structural changes in the financial services industry.

12. *Id.* at 189.
13. *Id.* at 193-94.
14. *Id.* at 196.
15. Cooper and Fraser predict that price base competition will improve resource allocation and insure equitable consumer treatment. *Id.*

The analysis of the impact of bank regulation and deregulation on the financial services industry is the strongest part of the authors' work. Tracing the development of bank regulation from its roots in the early history of this country, the authors explain the economic costs of our current regulatory regime. They explain that regulation necessarily imposes costs in the form of more expensive services, fewer competitors and impediments to free decision-making by bankers and consumers alike.[16] The result is an inefficient allocation of both the aggregate level and composition of banking services.[17]

Despite their pro-market attitude, the authors recognize that other pressures necessarily limit the freedom of the financial industry. A bank run can be explained as a rational response by depositors to perceived difficulties at a bank,[18] but when a run results in the loss of savings of thousands of depositors, economic theory must give way to political reality. In part, the authors' realism lapses, such as when they discuss whether depositors should exercise greater surveillance of their bankers' operations, rather than rely on the heavy hand of regulation and deposit insurance.[19] Generally, however, the authors swallow their point of view long enough to avoid polemics.

The authors apply their economic analysis to explain the origin and results of the two most significant banking statutes in recent years, the Depository Institution Deregulation and Monetary Control Act of 1980[20] ("DIDMCA") and the Garn-St. Germain Depository Institutions Act of 1982.[21] Their account of these two acts should provide a standard reference for students in years to come. The reforms brought by these acts—deregulation of interest rates, additional asset and deposit powers for both thrifts and commercial banks, and increased regulatory powers to manage failing institutions—altered the market for banking services dramatically. They changed banking from a tightly regulated, idiosyncratic part of the economy into a marketplace of financial services, in which the traditional dividing lines between investment and commercial banking, commercial banks, thrifts and nonbank banks became more difficult to discern and less useful. To their credit, the authors recognize that DIDMCA and the Garn-St. Germain Act were partly innovations and partly ratifications of the past changes in

16. *Id.* at 42-43.

17. *Id.* at 34-35. The authors argue that operational and allocational efficiency are best achieved through the "invisible hand" of a free market banking system. *Id.*

18. *Id.* at 40.

19. *Id.* at 161.

20. Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C.).

21. Pub. L. No. 97-320, 96 Stat. 1469 (codified as amended in scattered sections of 12 U.S.C.).

the banking world.[22] The authors also recognize what these acts omitted: final abolition of geographic boundaries, further expansion of financial products and services and equal regulatory treatment for all financial institutions offering the same products.[23] Those omissions remain a continuing source of controversy in Congress today.

The authors save some of their most provocative analysis for a discussion of the impact of deposit insurance on the banking system. According to the authors, deposit insurance is a substitute for the free exchange of information typical in an open market and for the harsh discipline—runs and panics—the market otherwise would impose.[24] The authors critically evaluate the justification and impact of deposit insurance and demonstrate that it is far from cost-free. Deposit insurance entails a wide array of regulatory compliance costs—in addition to the premiums paid by banks[25]—and may produce an inefficiently large number of banking firms. Most important, the availability of deposit insurance makes complete deregulation of financial services impossible: where both depositors and bank managers are freed from risk of failure, regulation may be needed to provide the risk-management function previously supplied by the market in the form of runs and panics. As the authors make clear, the presence of deposit insurance changes the risk equation for both depositors and managers.[26]

From their vantage point, before the near-collapse of Continental Illinois and the disastrous runs on thrifts in Maryland and Ohio, the authors' skepticism about the usefulness of deposit insurance may be understandable. Is it realistic, however, to believe as the authors do that deposit insurance really makes bank managers less risk-averse?[27] In the wake of the Ohio and Maryland runs, is it apparent that equity and efficiency would be truly served if depositors assumed greater responsibility for overseeing the security of their investments? As the authors state, "a greater reliance on the market mechanism for assuring proper functioning of depository institutions in the United States financial system may require an increased willingness to allow depository institutions to fail."[28] In the wake of the rescue of Continental Illinois, that willingness does not appear to exist. The Continental Illi-

22. BANKING DEREGULATION, *supra* note 1, at 122, 140-41.

23. *Id.* at 120-22, 139-40.

24. *Id.* at 161 (citing Diamond, *Bank Runs, Deposit Insurance, and Liquidity,* 1983 J. POL. ECON. 401-19 (1983)).

25. Increased bank premiums reduce investors' returns, depositors' yields, customer services and employees' wages. *Id.* at 162-65.

26. *Id.* at 163, 169-70.

27. *See id.* at 162-63. The authors suggest that insured institutions are likely to increase asset risk because of the reduced risk of bankruptcy and lessened depositor scrutiny. *Id.*

28. *Id.* at 165.

nois episode also refutes the authors' suggestion that uninsured deposits may act as a restraint on the risk-taking of bank managers.[29] Current proposals to reform deposit insurance—many of which are anticipated by these authors[30]—demonstrate that, for better or worse, deposit insurance is here to stay.

The authors anticipated other trends in bank regulation that more closely match our recent experience. They predicted accurately the increasing role and potential dangers of brokered deposits.[31] They recognized the increasing concerns over bank profitability,[32] but failed to foresee cases where some financial institutions would make record profits while the annual rate of bank failures accelerate. They also anticipated the current trends of bank consolidation, specialization, and geographic expansion.[33] Their recognition of the unequal impact that the failure of large versus small institutions has on the banking system was particularly prescient: "While it is very unlikely that the failure of a small bank will produce a financial panic, the failure or the rumor of failure of one of the nation's largest banks may produce such an effect."[34] Several times since the publication of this book, that conclusion has been verified.

One distressingly accurate forecast is the slowdown in the trend toward bank deregulation.[35] Indeed, proposals abound to impose new regulations, such as interest rate limits on some credit card accounts, and to reverse important experiments such as limited-purpose (nonbank) banks. While the impact of accelerating bank failures and the near panic conditions resulting from the collapse of deposit insurance in some states should not be forgotten, the clock cannot be reversed now. Many of the causes of the current stress in banking are due to incomplete, rather than excessive, deregulation. Stresses will continue so long as the products and geographic markets of financial institutions are artificially limited by regulation. If banks are to compete against nonbanking firms, they must be given a level playing field. That will require further innovations in products, new service providers and a change in regulations. The new products and services which have been provided to customers in recent years cannot be outlawed, nor can the system return to the rigid practices of a decade or two ago.

Thus, bankers and observers like Cooper and Fraser are con-

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29. *Id.*

30. Cooper and Fraser examine a number of proposals to change the deposit insurance system. *Id.* at 168-81. These include one hundred percent deposit insurance, *id.* at 169-71, and risk-related deposit insurance premiums, *id.* at 173-76.

31. *Id.* at 236-38.

32. *Id.* at 212-14.

33. *Id.* at 215-17.

34. *Id.* at 224.

35. *Id.* at 238.

fronted with two conflicting realities. On the one hand, they foresee depository institutions competing with new products in a new, free market of financial services with a range of competitors. Yet, at the same time, the painful experiences of depositors in Ohio and Maryland and farmers in the midwest demonstrate that most Americans still expect their depository institutions to offer, at a minimum, safekeeping for their savings and a ready supply of credit on reasonable terms. It may be that banking will continue to have one foot firmly in the future and another in the past—with all the dislocations that entails.

The way to bridge this gap is not through reregulating the financial bank into the tight restrictions it had labored under in the past. The path must be towards further deregulation which aims to resolve these dilemmas through innovation and experiment. The ultimate value of Cooper's and Fraser's work may be that it demonstrates that, almost in spite of ourselves, we have come a long way towards these goals already.