The Future of U.S. Banking: A Modest Legislative Agenda to Encourage Competitiveness

John B. McCoy*

As a banker viewing the public policy issues that confront the financial services industry today, I am heartened by the vigorous debate that is taking place in this journal and others like it. The ability and likelihood of policy-makers deciding upon the wisest directions can only be enhanced when alternatives are explored in depth and the faults and weaknesses of each position are thereby exposed. The need for such debate to illuminate prudent and sagacious choices has never been more urgent. The United States banking system is undergoing the most fundamental and far-reaching change since the Depression. Yet our lawmakers in Washington have so far failed to come to grips with the situation and change is thus occurring without the benefit of a well-defined federal blueprint.

It is important to recognize that economic forces in banking and commerce do not respect the boundaries of man-made laws and will cause change regardless of what laws are in effect. The history of banking in the United States is replete with examples of new products and services being introduced without legislative sanction or even regulatory approval, with the result being that the law was defined by the marketplace rather than the process that any civics book would describe. In our modern era, certificates of deposit (CDs) were developed in 1961 by Citibank as a way of circumventing long standing federal interest rate limitations on short-term deposits in order to compete with the Treasury bill for larger corporate deposits. In order to provide retail customers with a brokerage account that could be accessed by both checks and a credit card, my organization, Banc One Corporation, helped Merrill Lynch in 1976 to introduce the Cash Management Account and thus initiate the first of many inroads against Glass-Steagall[1] restrictions. Interest rate restrictions on consumer accounts could not withstand the dual attack in the late 1970s of inflation and deposit substitutes offered by thrifts and money market funds, and were finally removed after they had ceased to have any useful economic purpose. I believe it was also such economic forces that led to the removal of long-established geographic restrictions on bank expansion and entry. In Ohio, for example, the failure in 1985 of the Home State Savings Bank and other privately insured thrift institutions necessitated the infusion of out-of-state capital provided by a New York banking institution to enable several thrifts to satisfy their depositors' claims, and thus resulted in the Ohio legislature passing a regional interstate banking law to insure equitable treatment to those Ohio banks that wished to expand beyond our state borders. Indeed, it may seem that in many cases, lawmakers will approve important

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* B.A., 1965, Williams College; M.B.A., 1967, Stanford University. Mr. McCoy is currently the Chairman and Chief Executive Officer of Banc One Corporation. The author would like to acknowledge the assistance of Roman J. Gerber and Lee S. Adams in the preparation of this Article.

1. Glass-Steagall Act, ch. 58, 47 Stat. 56 (1932) (codified as amended in scattered sections of 12 U.S.C. (1982 & Supp. IV 1986)), and The Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C. (1982 & Supp. IV 1986)).

legislative changes only after economic forces have succeeded in circumventing existing outdated statutes. Often it is the fear of the results that any change will bring that causes this legislative paralysis.

The economic forces that are currently at work in the world of banking are significant and have already resulted in a massive upheaval of the old order. Resembling a process in which only the fittest survive, this upheaval has been referred to by one observer as Darwinian banking.[2] Consider for a moment that in ranking the ten United States banking organizations with the largest market capitalization, only four currently on the list were there in 1980. While thirty years ago, seven of the world's largest banks were based in the United States, today only one ranks in the top twenty-five. Also, a recent article on banking in a respected journal began "American commercial banks have a choice: They can change or they can die."[3] It is ironic to observe that in the midst of such a competitive upheaval, many of our legislators continue to view banks as quasi-public utilities whose social welfare obligations are of primary importance. It is in the context of the change that the United States banking system is already undergoing that public policy needs to be formulated, and must be premised on the realities of the world, not merely our wishes about how we would like the world to operate. Furthermore, the reality we must ultimately confront in all our thinking is not how well banks in one state can compete with those in other states, but how well the American banking system can compete with those of other countries such as Japan and West Germany.

A few years ago, many Ohio bankers and legislators would have viewed the approach of October 17, 1988 with fear and apprehension. An invasion of large unfriendly predators would have been seen as imminent. After October 17, 1988, Ohio law no longer restricts the ownership of Ohio banks to bank holding companies located either in Ohio or a region of bi-contiguous states and instead permits such ownership on a nationwide basis. The old conventional wisdom was that ownership restrictions were needed to insure local ownership because only locally owned banks could be knowledgeable about the needs and circumstances of smaller businesses and individuals. It was thought that once ownership restrictions were removed, there would be an immediate feeding frenzy of large money-center banking organizations from New York, Illinois, Texas, and California rushing into Ohio to buy all of our local banks and moving the decision-making power out of Ohio to cities geographically and philosophically distant. I do not feel particularly bold in predicting that such a revolutionary and unsettling scenario is unlikely to occur. In part it is based on the observation that only one large bank in Ohio so far has been acquired by an out-of-state institution in the approximately two years that Ohio's current interstate banking law has been in effect. This is not to say, however, that evolutionary changes will not occur in the next few years in which ownership of an Ohio bank may be transferred to one in New York, Illinois, Texas, or California, but indeed it is just as likely that one or more Ohio-based banking organizations will be the acquirers of

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2. *See A Survey of International Banking*, THE ECONOMIST, Mar. 26, 1988, at 5.
3. Andrews, *The Remaking of America's Banks*, INSTITUTIONAL INVESTOR, Mar. 1988, at 98.

banks in those four states, just as they have been in the states bi-contiguous to Ohio that now form our interstate banking region.

My reason for making this prediction is not to argue that bank acquisitions by out-of-state organizations are either good or bad. Rather, it is to make the point that as a general rule the modernization of archaic banking laws will not lead to the nightmares that many have predicted, but rather will result in acceptable change that will enable banks to survive and prosper in a financial world that is becoming increasingly more competitive and global. As in other areas, the conventional wisdom on why a particular banking law should not be changed is often wrong. Yet, while the pace, scope, and complexity of banking have increased dramatically in recent years, legislative recognition of these developments has been slow in coming. Change is thus occurring in the context of a legal and statutory framework that is outdated and inadequate to meet the challenges currently before us.

In this maelstrom of change, the United States Congress to date has not played a very visionary role. The reasons why Congress has acted so cautiously include factors such as concerns about the safety and soundness of the banking system, the desire not to offend any group or industry that opposes changes to the status quo, particularly the well-financed lobbying efforts of the securities and insurance industries, and finally a lingering populist distrust of banks that dates back to Revolutionary War times. Recently, there have been indications that Congress may be prepared to act to modernize our federal banking laws. In enacting the Competitive Equality Banking Act of 1987,[4] Congress appeared to recognize that it was time to act and time to initiate "a comprehensive review of our banking and financial laws and to make decisions on the need for financial restructuring legislation in light of today's changing financial environment both domestic and international. . . ."[5] One hopes this statement signals a genuine intention to act rather than the initiation of a study as a way of avoiding difficult decisions.

Recognizing that immediate attention cannot be given to the entire spectrum of financial industry issues, there are three areas that I believe Congress has a particular role to play in helping make this banking evolution occur in a sensible fashion. The first issue needing resolution is the fiscal crisis surrounding the Federal Savings and Loan Insurance Corporation. The second is a review and rationalization of the present crazy-quilt pattern of interstate banking legislation, and the third is the removal of the statutory barriers that prohibit banks from offering various securities, real estate, and insurance products to their customers.

The first area of concern to banking and the financial system generally that the upcoming Congress needs to address is the precarious financial condition of the governmental entity responsible for insuring deposits of the thrift industry, the Federal Savings and Loan Insurance Corporation (FSLIC). Although it has been an article of govermental policy for several decades to view the banking and thrift

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4. Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552, *reprinted in* 1987 U.S. CODE CONG. & ADMIN. NEWS 566–72.

5. *Id.* § 203(a), at 584.

industries as separate and distinct, any resolution of the FSLIC crisis is likely to significantly affect the banking industry for the following reasons. First, despite official policy, banks and thrifts directly compete with each other in several areas, primarily in the consumer deposit and loan markets, and such competition will be impacted by the outcome of this legislative process. Second, the enormity of the FSLIC financial crisis will preempt Congress' attention to any matter involving banking and finance, and thus a successful and speedy resolution of the FSLIC problem is needed for Congress to begin focusing on the modernization of the banking system. Third, also due to the enormity of rescue effort that FSLIC will require, efforts will be made to make the banking industry subsidize a portion of that rescue.

The FSLIC crisis has arisen because of the billions of dollars that the thrift industry has been losing during the past several years. The result has been a dramatic increase in the number of insolvent savings and loan associations. This situation is exacerbated by regulatory and legislative paralysis that enables both insolvent and marginally capitalized thrifts to continue functioning and thus losing more money for which FSLIC is ultimately accountable. It is sobering to note that according to a General Accounting Office study published in 1987, almost fifteen percent of the nation's operating thrifts had a negative net worth and these savings and loans would, if liquidated, by themselves exhaust *all* available reserves in FSLIC.[6]

I believe there are several premises upon which any legislative approach to a FSLIC rescue must be based. As an initial starting point, the need for a separately regulated housing finance industry must be carefully examined. I suspect the outcome of such a review will be that the thrift industry as we know it today will be regarded as largely duplicative of other sources of such liquidity. Secondly, Congress must demand and support prompt action by federal regulators to close insolvent institutions and to impose sound capital standards for thrifts that are comparable to those of banks. Thrifts that are unable to meet such standards after a reasonable adjustment period should be closed or merged into healthy institutions, both thrifts and banks alike. Finally, a ready source of liquidity exists to begin paying off this huge deposit insurance debt. Both banks and thrifts are obligated to maintain reserve balances at the Federal Reserve Banks. The Federal Reserve Banks do not pay interest on these reserve balances, and instead turn over to the U.S. Treasury the net earnings that result. If interest were paid on these reserve balances and allocated to FSLIC, it seems likely that over an extended period of time, the substantial earnings generated could be sufficient to restore the fund to financial stability. At such time, whenever it occurs, the Reserve Banks should be required to pay the interest payments directly to the financial institutions that are maintaining these required reserve balances.

Geographic barriers are the next area I would like to see Congress address. For

6. U.S. GENERAL ACCOUNTING OFFICE, THRIFT INDUSTRY: THE TREASURY/FEDERAL HOME LOAN BANK BOARD PLAN FOR FSLIC RECAPITALIZATION (1987).

many years both the McFadden Act[7] and the Bank Holding Company Act[8] prevented banking organizations from operating full-service banking offices across state lines. Pressure to modify these statutes began to build in the 1970s and early 1980s, but no effective coalition was ever put together to persuade Congress to act. Fortunately, state legislatures were not so paralyzed, and beginning with the geographically remote states of Maine in 1975 and Alaska in 1982, barriers began to fall. Most significantly, a series of states in New England and the Southeast enacted statutes in the early 1980s that permitted entry by out-of-state bank holding companies located in nearby states. These so-called regional interstate banking statutes became the model for other states to adopt as a way of gradually permitting interstate bank expansion to occur. Thus, by mid-1988, a total of forty-seven states and the District of Columbia had passed legislation that permitted interstate banking on either a regional or national basis. Twenty of these states permit such expansion nationally. Of the twenty-nine states that have adopted regional restrictions in their interstate legislation, twelve (including Ohio) have provisions that will permit nationwide entry after a specified trigger date.

Now that a significant majority of states have adopted laws that permit some measure of interstate banking, banking organizations that have expanded to take advantage of these new opportunities have begun to encounter difficulties in reconciling the inconsistencies and peculiarities of the different states. To cite but one example, Ohio law currently provides for an interstate region of all fourteen bi-contiguous states (including, of course, Indiana) and will soon provide for nationwide entry on a reciprocal basis. Indiana law provides for a slightly more compact region of twelve states (including Ohio) but further requires that any non-Indiana banking organization in the region that owns an Indiana bank must maintain eighty percent of its deposits in subsidiary banks located within the Indiana interstate region. The effect of this is that an Ohio bank holding company, such as Banc One Corporation, while legally entitled to own banks outside of those states in the Indiana region, is precluded by the deposit size restrictions from entering one of those states if the bank(s) it acquires would dilute its deposit base in the Indiana region to less than eighty percent. To further complicate the situation, another state in both the Indiana and Ohio interstate regions, Pennsylvania, requires that an out-of-state acquirer in its eight-state interstate region must maintain seventy-five percent of its total deposits in bank subsidiaries located in states that accord reciprocity to Pennsylvania. Of the eighteen states in the combined interstate regions of Indiana and Pennsylvania, these interstate regions only share four states in common. While it is mathematically possible for an Ohio-based holding company to maintain sufficient deposits in the four states that Indiana and Pennsylvania both include in their regions, the practicalities of such a complex arrangement make it most difficult to administer.

My hope is that Congress will act to provide some uniformity and consistency

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7. McFadden Act, ch. 191, 44 Stat. 1224 (1927) (codified as amended in scattered sections of 12 U.S.C. (1982 & Supp. IV 1986)).

8. Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 (codified as amended in scattered sections of 12 U.S.C. (1982 & Supp. IV 1986)).

to these conflicting state laws. While the Congress displayed little enthusiasm in an earlier period to remove barriers to interstate expansion of banks, the most controversial issues that caused the legislative paralysis have been dealt with by the various state legislatures in enacting their statutes. As the trigger date for nationwide entry approaches in a number of states, the resistance to any congressional action ought to be much less. For example, as described previously in this Article, a significant concern during the 1970s was that money center banks, if so authorized, would gobble up regional and community banks across the country. However, during the time that the various state laws have been in effect, a number of regional bank holding companies have grown significantly larger, thus making them less likely to be acquired by the money center banks. In addition, the ability of money center banks to expand at all is likely to be constrained by the burden that Third World debt has placed on their balance sheets and by the higher capital requirements that the federal bank regulators have recently established and which are due to become effective in 1992. Thus, Congress should be able to proceed to rationalize and provide some uniformity to the variety of interstate bank statutes without needing to confront the divisive and emotion-laden issues that prevented action in the previous decade.

The most serious statutory impediment currently facing the banking industry are those laws that restrict the ability of banks to offer a variety of financial products to their customers. The most sweeping of such laws is the Glass-Steagall legislation that was passed during the Depression to require the separation of commercial from investment banking, and thus places a litany of securities products off-limits to commercial banks. Other significant financial products that are restricted by other laws from being offered by banks include insurance and real estate. I believe the fundamental premise upon which Glass-Steagall reform must begin from the public policy standpoint is that the continued maintenance of this barrier threatens the long-term viability of American commercial banks. Ironically, commercial bank viability is diminished by the decline in profitability of traditional banking products due to increased competition from nonbanking firms in offering these products or their substitutes. For example, Federal Reserve data shows that in 1985 bank profitability was at its lowest level in fifteen years while the market share of commercial banks in the commercial loan market declined from over forty-three percent in 1974 to about twenty-seven percent in 1985,[9] primarily due to corporate customers who use investment banks to obtain credit through the commercial paper market. What is thus occurring is that commercial banks are being challenged by nonbanking organizations that are seeking to become modern financial mega-firms that not only offer the same services as banks but much more.[10]

In addition, U.S. banks are increasingly losing business to foreign banks whose

9. Federal Reserve Bank of New York, *The Recent Performance of the Commercial Banking Industry*, Q. REV., Summer 1986, at 3.

10. It is noteworthy that in a 1987 poll of consumers conducted by the *American Banker*, Sears, Roebuck & Co. was selected by more consumers as being best able to meet their financial service needs than any other financial organization. Rosenstein, *Consumers Say Sears Best Meets Financial Service Needs*, AMERICAN BANKER, Sept. 28, 1987, at 1, col. 2. Martin Mayer also wryly noted that a slogan for Sears Financial Services might be: "If you lose your shirt, we'll sell you another." M. MAYER, THE MONEY BAZAARS 34 (1984).

countries do not separate commercial and investment banking. With greater competition taking place in overseas financial markets, borrowers can obtain more economical terms. Thus, many foreign borrowers have abandoned U.S. banks for their financing, and each year more U.S. companies are looking to European and Japanese banks rather than their American counterparts for their borrowing needs.

Of critical importance in advancing the debate on this issue is the need for recognition by all that the historical premise of the Glass-Steagall Act, that the stock market crash of 1929 and the subsequent collapse of the banking system in 1933 were due to bank securities activities, is misplaced and inaccurate. Ample evidence is now present to refute this notion, but it is not yet clear whether the evidence has been sufficiently absorbed and understood by those involved in making public policy. What is clear, however, is that opponents of reform will continue to promote these well-worn arguments that serve to protect the securities industry's cartel-like profits. Thus, while there is no dispute that the October 1987 stock market crash occurred without the participation of banks in the securities markets, the securities industry's rejoinder has been that the crash would have been that much worse if banks had had securities powers.

In proposing the removal of Glass-Steagall barriers, one needs to do so in a responsible manner and thus needs to be cognizant of the regulatory apparatus that would likely be needed to replace it. The objectives must be to insulate a bank from undue risk, to warn investors of the nature of their risk, to prevent conflicts of interest, and to meet safety and soundness concerns. This task is straightforward and only becomes complex if extraneous factors such as industry protectionism are given consideration. Bank deposits, which carry federal deposit insurance, should be insulated from any risks associated with newly-authorized securities activities. As banking organizations are empowered to offer new products, these services ought to be conducted in a subsidiary that is distinct from the federally insured bank.[11] While there would be a need to insure a layer of legal insulation between the bank and the securities affiliate, it is fortunate that such protection has already been enacted in sections 23A and 23B of the Federal Reserve Act,[12] which place limits on loans and other transactions in which these affiliated entities can engage. Finally, the securities affiliate of a banking organization ought to be subject to the same provisions of federal securities laws that securities firms are, with oversight and enforcement conducted by the Securities and Exchange Commission.

In contrast to the selling of securities products, the arguments against permitting banks to sell insurance or real estate have not been related to the safety and soundness of these activities. Instead, these industries have argued that giving banks such powers would tend to concentrate too much power in banks and could lead to bank customers being pressured or forced to obtain their insurance or real estate servicing needs from their banks. Regrettably, it has not proved sufficient to demonstrate that

11. Those securities activities, however, that banks already offer should not be required to be moved to a securities affiliate.

12. Federal Reserve Act, ch. 6, §§ 23(a)-(b), 38 Stat. 251, 272-73 (1913) (codified as amended in scattered sections of 12 U.S.C. (1982 & Supp. 1986)).

federal law already precludes banks from engaging in such practices. Moreover, insurance agency services in particular entail little risk and banks have safely engaged in such services for many years. Further, allowing such activity is procompetitive. Permitting banks to offer generalized insurance agency services would result in lower insurance costs to the public and would enable banks to use their existing branching and data processing systems to modernize the delivery of insurance products.

This Article began with a discussion of how market forces cannot be controlled by artificial legislative constraints. Such forces are currently at work in chipping away the restraints imposed on banks as they attempt to satisfy their customers' needs for services in the areas of securities, insurance, and real estate. If this were an earlier time in our nation's history when our economy could be insulated from foreign competition, the preservation of legislative restraints could occur without significant harm to the banking industry. As we approach the last decade of this century, however, such a luxury does not exist. If Congress manages the process of granting new banking powers in the same manner that it has dealt with some other controversial issues such as geographic expansion, effectively providing no support and allowing the problem to be resolved by others, the ability of American banks to compete in a global economy will be seriously undermined.