Deregulation of the financial sector

The Conference on Bank Structure and Competition, sponsored by the Federal Reserve Bank of Chicago, serves as a forum for the exchange of views and research on a variety of issues facing the financial industry. Participants include academicians, economists, regulators, and executives of a wide variety of financial institutions. Their ideas endow the conference with both a theoretical and a practical perspective.

The 18th conference, held in April this year, focused on interest rate risk and deregulation, two key industry concerns. Following are excerpts from papers delivered at a session entitled "Deregulation of the Financial Sector." The full text of these papers and the remainder of the 1982 Proceedings will be published in October.

Implications of deregulation for product lines and geographic markets of financial institutions

*George G. Kaufman, Larry Mote, and Harvey Rosenblum**

Recent changes in financial markets have been sweeping: NOW accounts, failures of large banks and thrift institutions, creation of money market mutual funds, Merrill Lynch's cash management account, American Express's acquisition of Shearson, Sears' acquisition of Dean Witter, and interstate mergers of savings and loan associations. Two primary driving forces behind the recent innovations are the unexpected and abrupt increases in the level and volatility of interest rates and the major technological improvements in the transmission, processing, and storage of information. The impact of interest rate volatility and technology on the financial system was much more dramatic and severe than it otherwise might have been because of a third factor—the existence of a pervasive system of regulations that limited and distorted the responses of existing financial institutions and contributed to the emergence of new institutions.

Many of the regulations that banks face were written in haste during the financial panic of the 1930s, predicated on the belief that banks must be sheltered both from competition and from their own poor judgment. Unfortunately, the restrictions imposed on banking remain nearly a half century after they were first introduced.

The last two decades have become a contest of wits and wills between the regulator and the regulated. Blocked from competing on rates, banks tried to compensate by offer-

*Mr. Kaufman is the J.F. Smith, Jr. Professor of Economics and Finance at Loyola University of Chicago and serves on the editorial board of four professional journals.

Mr. Mote is Vice President and Economic Adviser at the Federal Reserve Bank of Chicago and a Lecturer in Finance at DePaul University.

Mr. Rosenblum is Vice President and Economic Adviser at the Federal Reserve Bank of Chicago and has served as Adjunct Professor of Finance at DePaul University for the past ten years.

ing greater convenience. Banks also sought to escape their perceived chains through the device of the one-bank holding company whose subsidiaries were free to enter almost any activity that they wished until 1970.

The Depository Institutions Deregulation and Monetary Control Act of 1980 will provide benefits in the form of a modest improvement in the technical means for monetary control, more equitable treatment of competing financial institutions, and most importantly, a greater ability of depository institutions generally to meet the competition of unregulated competitors and to withstand interest rate fluctuations. The Monetary Control Act, however, was silent on many regulatory issues, and it is in these areas that the battles are being fought. For example, de jure geographic restrictions on banks and other financial institutions remain, although they are slowly giving ground. The spirit and economic substance, if not the letter of these restrictions have been trampled on. Not only have geographic restrictions been circumvented, but the same holds true for product-line restrictions. The distinctions between traditional forms of depository and nondepository financial institutions continue to erode as each tries to expand the scope of its activities.

The most dramatic expansions by financial institutions have been the recent incursions by nondepository financial institutions into areas of business where they were not previously represented. The inroads of basically nonfinancial businesses into the financial sector also continue. It is easy to exaggerate the significance of this expansion; the fact is that commercial banks have roughly held their own in most of their major markets over the last two decades.

Of course, this is subject to change. Technological advances pose a threat to the hegemony of depository institutions in the financial services business. To survive and prosper, they not only have to utilize state of the art credit information processing technology, but they also need to maintain a source of funding that is cheaper than that obtainable by such nonfinancial information-processing firms as, say, TRW or Dun and Bradstreet. This is not to say that banks need fear for their survival. Banks have an excellent record of earning profits and have been doing so for a long time.

The financial services industry of the future is unlikely to consist of the same familiar types of institutions that we know today. In the deregulated environment, banks should find it more efficient to compete for deposits by paying higher rates and to avoid some operating costs by closing down some branches. A consolidation movement in banking should begin in the very near future, but there should continue to exist a large number of smaller, retail-oriented banking or thrift institutions. We will likely end up initially with about 25 or so fully integrated national financial conglomerates. It is likely that several of the leading financial services conglomerates will disappear through bankruptcy or merger, and we will be left with at most a dozen national firms. The importance of the "one-stop, one-shop" convenience offered by such firms is easily overstated. The managements of many other institutions will choose to specialize; some managements may be convinced that they can perform a narrow range of functions better than anyone else.

The public policy questions raised by these developments are many, varied, and important. One of our major concerns has to do with whether existing antitrust laws are capable of dealing with the market and the aggregate concentration that will result from the developing consolidation movement. Another area that we would like to see given more attention is the adoption of risk-related federal deposit insurance premiums. Without this change, deregulation will not go very far.

The coming years promise to be interesting ones for financial institutions. The financial system that we have today was designed and built for a more stable economy than the one we have witnessed in recent years. In the past, the unique attributes and capabilities that distinguished banking as a well-defined

industry were largely the product of regulation. With the demise of these artificial barriers, the notion of banking as a separate and distinct industry will slowly but inexorably disappear. If the present level of economic volatility continues, then after a period of initial turmoil we can expect greater stability and a less fragile financial system that responds promptly and efficiently to the needs of its customers.

The future competitive environment: strategic planning for the 1990s

*Sanford Rose**

The banking industry is beginning to contemplate its inevitable transition from the business of money brokerage to that of marriage brokerage. In the coming years, an increasing portion of bank income will be derived from introducing those who are cash rich to those who are cash poor without actually borrowing from the one in order to lend to the other. And by the end of the decade, banks may make more money on the flow of assets through (and around) their balance sheets than on the stock of assets on those balance sheets.

In the past, banks made money in two basic ways. Their "front-end" profit came from the ability to analyze and evaluate credit risk. Supplementing this primary profit was a return that persisted over the life of the loan assets the banks created. This return, dubbed the funding profit, was essentially derived from the normal, or upward-sloping shape of the yield curve.

However, the behavior of the yield curve has become increasingly erratic in the last few years. Indeed, the yield curve has inverted so often in recent years that some banks have taken to lending shorter than they borrow—the reverse of the historical pattern. But that tactic doesn't work too well either. In the last few months, the yield curve has moved from a negative to a positive slope and back again with dizzying rapidity. Bankers are becoming increasingly uncomfortable borrowing at a maturity either much shorter or much longer than that at which they lend. Now that Regulation Q is eroding, banks no longer have much scope to gamble on interest-rate turns. Soon there will be no scope at all.

But if a bank plays it safe and matches the maturities of its loans and investments to those of its increasingly rate-sensitive deposits, there can be no funding profits. Many banks, however, are unreconciled to the notion of relinquishing their funding profits. So despite the growing amount of lip service being paid to maturity balance, many banks selectively mismatch their maturities. These institutions are willing to take on a considerable amount of risk in order to achieve what they believe will be a higher level of profits. Sometimes the gamble pays off; sometimes it doesn't.

There is, however, a way to reduce risk and at the same time raise the return on stockholders' equity. If banks can increase their leverage—the volume of loans both on and off the balance sheet per dollar of equity capital—the return on equity will rise. But the level of permissible leverage depends quite crucially on the amount of risk banks assume. Of the two basic types of risk in banking, credit risk and interest-rate or funding risk, by far the more important is funding risk. If banks therefore eschewed the elusive pursuit of interest-rate profits, they could reduce overall risks quite substantially. They could increase the volume of loan extensions per dollar of existing equity without frightening the regulators or the financial marketplace.

---

*Sanford Rose is Financial Editor of the *American Banker*. He was formerly a member of the Board of Editors at *Fortune*.

Most borrowers want long-term fixed-rate credit, preferably of five to seven years' duration. To finance such loans without seriously mismatching their portfolios, banks need multi-year fixed-rate deposits. Since banks have not gotten much long-term money, they haven't made many long-term loans. If banks can't get long-term money from their depositors, can they perhaps get it from nonbank investors? If banks sold, or more precisely brokered many of the long-term loans they made, they could conceivably extend much more five-year credit, in effect escaping from the tyranny of their rather rigid deposit structures.

Although many banks seem anxious to sell loans, the desire may be more theoretical than practical. Many bankers are emotionally unprepared to become mere conduits for loan transactions. The concept of off-balance sheet leverage is foreign to them. Then too, there seem to be some powerful organizational constraints. It is my thesis that once organizational obstacles to loan sales are surmounted, banks will use the following mechanism to broker loans. For loans that must be sold with recourse, the bank will offer a letter-of-credit guarantee and then drop the guaranteed loans into a special-purpose corporation organized by a Wall Street house. This corporation will then issue its own securities backed by these loans and stand ready to make a secondary market in the new securities. The loan-backed securities will be marketed to the unit investment trusts and the bond funds. The theory is that while institutional sources of funds are limited, the retail investor has an untapped yearning for good quality, liquid, intermediate-term securities. Given the greater likelihood that inflation will decelerate in the future, the retail investor would like to rebalance his portfolio, substituting shares of five-year loans for shares of money-market funds. Thus banks can find buyers for their loans, which means that they can resume making long-term fixed-rate loans, provided they can enforce prepayment penalties.

The future of banking: a community bankers perspective

*Lee E. Gunderson**

There has been a lot of rhetoric lately about competition and how difficult it is for banks to labor under the regulatory burdens imposed on them when money market mutual funds—and now even Sears—are moving in on what had traditionally been bank markets.

It is true that it is tougher these days to run a small bank profitably. It is true that the financial services marketplace has changed dramatically in the past decade. If community banks are straining their resources under the weight of the competition, they would be wise to call out the reinforcements. They will need to make the best use of *all* the tools and *all* the resources at their disposal in meeting the challenges that deregulation is bringing.

While it is necessary to plan for a free market approach to financial services, it is also important to keep in mind that there is still work to be done to make this free market a reality. Deregulation is discussed as if it were already an accomplished fact. While it was mandated by the 1980 omnibus banking law, implementing the new and phasing out the old is proving to be no small task. What banks, and all other members of the financial services industry, need is a well-managed transi-

*Mr. Gunderson is President and Chief Executive Officer of the Bank of Osceola, Wisconsin, and Chairman of the American Bankers Association (ABA) Council. In 1980-81 he served as President of the ABA.

tion to deregulation to minimize the guesswork involved.

The Depository Institutions Deregulation Committee's pledge to provide a predictable schedule for the phaseout of the differential and Regulation Q is of immediate concern to bankers. While the Deregulation Committee did establish a specific phaseout schedule earlier this year, assurance is now needed that the Committee will abide by its decision.

In looking ahead, it appears that the national landscape will be dotted coast-to-coast with community banks that have survived the deregulation process and have adapted to change. Deregulation will certainly not lessen the need for what community banks all over the country do best.

Knowledge of the market, as well as of more advanced marketing techniques, and knowledge of new technological and regulatory developments affecting the industry form the buttresses for a solid and prosperous community banking structure in this country. Not only are community bankers finding more competition from nontraditional sources, but they are also seeing even tougher competition from other depositories. All of this has had the effect of discounting the traditional concept of a bank charter.

Product development is one of the areas in which community banks will be forced to become more competitive. Deregulation opens the door to new products and services, but profitability will depend on the creative design, development, and pricing of those new products and services. Effective product development for the community bank will mean maintaining a clear-eyed view of reality that accommodates innovation to the proper scale.

Community banks, as well as other depositories, must also prepare now for the increased emphasis on fee-based selling. Fee income generated by expanded real estate powers, insurance powers, and securities powers will bring new sources of profitability. Learning to manage this concept and adapting it to the business of community banking are immediate challenges for community bankers.

There is a great deal of enthusiasm for these new opportunities among community bankers. The public is already becoming acclimated to the idea of fees for services. When faced with the reality that banks cannot offer services that are unprofitable, bank customers will accept this new way of doing business as it is dictated by the marketplace. Anticipating how to build fees into new products should be an important component of a community bank's strategic planning.

Change should not be awaited passively and with trepidation. The new era of deregulation will bring *more* opportunities for community banks. The responsibility for the destiny of each and every community bank, however, rests with each bank's directors and management.

The future of banking: a national market and its implications

*Alex J. Pollock**

Managers of banks, managers of investment companies, and others unabashedly talk about how competitors are entering "*our* markets, *our* turf, *our* states, *our* region." This *our* is a scandal: it suggests the belief that a certain competitor or group of competitors should own a market or a *turf*, in other words, a set of customers.

The force causing these comments is the evolution of a true national market for finan-

*Mr. Pollock is Vice President of Operations and Management Services and head of Corporate Planning, Research and Development for Continental Illinois National Bank and Trust Company. He is also an active member of several banking associations.

cial services brought about by communications, technology, and travel. The development of nationwide competition is most frightening and upsetting to banks which have a strange fixation on state boundaries. When viewed from the perspective of other industries, however, this fixation seems bizarre. Imagine someone making the argument that cornflakes from Michigan should not be sold in Minnesota because they would compete with the local products.

Of the financial industries, banking is by far the largest. This huge industry is, however, extremely fragmented, the result of regulations, contrived during the Depression era, which try to guarantee banking profitability by limiting competition through geographic barriers. These barriers have caused the current fragmentation and the pain involved in the transition to a national competitive market. If, however, we take the formation of a true national market as the dominant theme for the 1980s and 1990s, then I believe there are three fundamental implications: excess capital in banking, reregulation, and differentiation.

One of the most discussed topics in banking is its capital shortage. The case is exactly the opposite: banking has a capital excess. There is too little profit in banking compared to the capital committed to it; therefore, bank stocks sell at substantial discounts from book value. In other words, relative to the earnings potential, there is too much capital already. In 1980, the banking system earned 13 percent on its book equity. The average return on book equity of the Standard and Poor's 500 stocks was 15.6 percent; the average return of investment-brokerage companies was 22 percent; and the average return of life insurance companies was 15.4 percent. Realizing their low rates of return, many banks have raised their profitability targets.

It seems unlikely, however, that the entire banking system will be able to raise its return without industry consolidation. This is especially the case if we consider the increasing risk to bank profitability from the well-publicized competitive challenge of others in the financial services business.

The demise of Regulation Q is well known and its crunching of the savings and loan business apparent. The dollar magnitude of the challenge its demise poses to commercial banking is not, however, always appreciated. There are still about $160 million of 5½ percent passbook savings in U.S. commercial banks, and with the market value of money at 13½ percent, passbook savings represent about $13 billion of vulnerable pre-tax earnings for the entire banking system. One of the adjustments to this situation will probably be a consolidation of the banking system as part of a larger consolidation in financial businesses. There are simply too many banks, too much brick and mortar, and too much overhead committed to the banking sector.

We have heard a great deal about deregulation of banking, but what we will certainly get is reregulation as opposed to deregulation for two fundamental reasons. The first is the abstract nature of financial assets and financial businesses which makes them particularly prone to creativity, imagination, and fooling people. The second reason for reregulation is that the central bank and the government will continue to underwrite the risk of savings. It is impossible for the government not to regulate financial companies in order to manage its own risk and to avoid the debacle of a system failure.

One possible element of reregulation is a limitation of the interest rate risk that may be undertaken by financial intermediaries. A second element in reregulation could be redefinition of capital requirements, perhaps on a formula basis like the "haircut" rules applied to securities firms. A third possibility, highly desirable although unlikely, would be lifting the reserve tax on banks. The tax is heavy; in the long run, the market will always find ways around a mechanism which has special taxes imposed on it.

Whatever its specifics, reregulation of banking will need to recognize the national market for financial services which reflects the integrated U.S. economy.

Every business strategy is in some mea-

sure a way to differentiate a company from its competitors. When product offerings are identical, as has been the case in banking, a large number of competitors can co-exist if the market is geographically divided. When a national market emerges, geographic differentiation erodes, and the competitors who survive must develop some other form of differentiation.

The challenge to the management of banks and other financial companies is to find the different path which takes maximum advantage of the existing combination of market needs and organizational competence. In one nationwide financial services market, a still large number of competitors can co-exist if they develop different strategic roles.

In a national market, these different roles will be less and less based on geography. They must then be based on specialized service to particular market segments, superior capability, or discovering and serving new financial needs. This is the most important theme for financial companies in their strategic planning for the 1980s and 1990s.

Planning for the 1990s from the perspective of a large diversified financial services company

*Herbert M. Allison Jr.**

The most widely accepted scenario of the financial services industry's future is that the financial world will become polarized into two main kinds of competitors: large, highly diversified firms, very similar in the scope of their businesses, and small boutiques servicing narrow niches of the market.

According to this scenario, the industry will become far more concentrated. Large firms will dominate and smaller firms will either go broke, merge into larger firms, or hunker down into a narrow specialty overlooked by the market leaders.

There seems to be much evidence supporting this prevalent view including a wave of mergers just getting underway, rapid diversification of large firms, and abolition or circumvention of regulatory barriers.

I'd like you to consider some reasons favoring an alternative scenario in which there is greater diversity among financial competitors than ever before, in which there is strong competition from many small and medium-size *diversified* firms, and in which there is great similarity in the challenges, choices, and opportunities facing firms of all sizes.

Until recently, financial firms could be placed into a few well-defined categories such as banks, thrifts, insurance companies, and securities brokers. Now, the decline of traditional and regulatory barriers gives firms many more options for defining their businesses and their orientations as well.

Companies can define their businesses to meet certain kinds of needs (financing, investing, insuring) for a wide variety of customers. Or they can define their businesses in terms of a certain type of distribution such as personal service or electronic delivery.

But no firm has—or will have—the expertise and resources to offer *all* kinds of financial products/services to *all* kinds of customers through *all* kinds of distribution systems. Although larger firms will overlap each others' businesses, they still must concentrate on certain areas or else they will risk becoming spread too thin and losing share to more focused firms.

The pace of change, driven by new technologies, new products/services, and economic and regulatory developments, will be so rapid and the ways for a firm to define its

*Mr. Allison is Vice President and Manager of the Market Planning Department of the Individual Services Group of Merrill Lynch.

business will be so numerous and the competition will be so fragmented that small and medium-size firms should have more opportunities to differentiate themselves and to compete effectively.

As an outgrowth, therefore, we're all going to be operating in a financial world which is almost incomprehensible in its complexity, and for that very reason, it will offer almost unlimited opportunities. It will also entail greater risk stemming from much keener competition and less regulatory protection for inefficient firms.

What must firms do in order to improve their chances of surviving and prospering in that environment? They'll have to rely much more on systematic experimentation in the marketplace to identify customers' needs and to develop the most appropriate mix of products/services, pricing, promotion, and distribution systems. Instead of simply trying to think their way to success through the use of formal planning, leading firms will rely more on groping their way through a well-organized process of trial and error, building a growing base of knowledge as they go. Understanding the natural interrelationships between customers' needs will be essential to building systems of services which create competitive advantages and greater profitability.

Another way that companies can position themselves for success is by maintaining flexibility to take advantage of change. Two techniques which successful companies will use are contingency planning and make-or-buy analysis. Contingency planning is based on the premise that no firm can accurately forecast the future. Therefore, the firm devises many different scenarios and arranges to have reserve resources and products/services available. Make-or-buy analysis is, for example, deciding whether to buy or lease a computer as opposed to using a timesharing facility.

Some firms will decide that the best way to maintain flexibility is to focus on packaging and distributing products and services manufactured by others, thereby transferring much of the business risk to outside suppliers.

One other determinant of success (as always) will be the quality of service. Successful firms won't allow the glamour issues (deregulation, diversification, and mergers) to distract them from the mundane but vital task of improving the quality of service.

But the overriding determinant of a firm's success in the 1980s will be the quality of its leadership. Leadership will be far more important than a firm's size or resources since each will have the opportunity to grow and thrive in the emerging financial services industry. But to do so they will need leaders with the courage to take substantial risks and to make major changes in traditional ways of doing business.

What a savings and loan can learn from General George Armstrong Custer

*Glenn C. Hansen**

Historically, the principal role of each type of financial intermediary was straightforward. Their markets were segmented. The commercial banks met the needs of "corporate America" and the international sector, and in some instances, they pursued the consumer market. Thrifts and community banks met the financial needs of households. Insurance companies provided for the continuation of income flow should premature death or disability occur in a household. Finance companies met the higher risk secured and unsecured borrowing needs of consumers.

---

*Mr. Hansen is Vice President of the Management Services Department of the Federal Reserve Bank of Chicago. Before joining the Bank in May of this year, he was Vice President and Corporate Planning Coordinator for First Federal Savings and Loan Association of Chicago.

The brokerage and investment intermediaries served the private capital market. And the mercantile companies sold refrigerators, in part because they provided financing as part of the deal.

We are now in a marketplace with new rules and new competitive roles. The traditional marketplace, with new segments, has been injected with new competitors. The economy certainly has impacted financial intermediaries. Now our economic system confronts us with a monetary policy designed to control inflation and a fiscal policy—expansionary in nature—with the hoped-for goal of stimulating saving and investment. We have experienced unimaginable short-term interest rates and now must confront the phase-out of interest rate ceilings on deposits.

The legal environment has also impacted competitive structure. The Depository Institutions Deregulation and Monetary Control Act of 1980 created a *potentially* level playing field by phasing out Regulation Q and granting new asset/liability powers.

It appears that interstate branching will soon be here; it is, in my opinion, only a short period of time before the McFadden Act will be amended and full interstate branching will be permitted. On the regulatory horizon, commercial banks are vigorously seeking to expand their bond underwriting authority and other privileges. Thrifts have been allowed to expand their markets by aggressive branching and now have new asset and liability powers. Thrifts also have the ability to use the Fed's discount window.

Technology has changed at an incredible rate. Nationwide automated teller systems, point-of-sale funds transfer systems and merchant cash register-to-financial institution transfer systems are a technological reality.

There has been a change in the value systems of people. The ethic of commitment and the idea of the family will be revived.

What does this collage of competitive, economic, legal, regulatory, and social changes depict for the financial services industry? It is obvious that the traditional segmentation has collapsed and the financial market pie is ready to be resliced. I believe it will be segmented by scale; there will be the mass marketers and there will be the market focusers. And each will have different managerial economics driving the bottom line.

Many aggressive thrift managers recognize that they are at, or near, the trough in this business cycle as it relates to their industry and have mapped strategies on which to concentrate. Associations that survive and prosper will be those who become market focusers. Market focusing begins with corporate self-analysis. Associations must find out who they are, identify their most profitable customers, and list those products that have the best acceptance and profit characteristics. Associations must define their markets in terms of geography, demographics, and products. They must analyze their markets and identify present competitors and likely future competitors. Lastly, they must determine their sources of competitive advantage and leverage one or more of them into a strategy or program to influence the relative market position in their favor.

R. K. Ready and Edward Ranelli of the University of West Florida discussed the possible roles thrifts may play in the financial market in a recent article in the *Federal Home Loan Bank Journal.* They identified the potential roles of mini-commercial banks, mortgage banks, real estate developers/financiers, and full-service family financial centers. To this I would like to add the concept of the "diversified family financial service company," which will function much like a consumer-level bank offering NOW accounts, credit card services, consumer loans, bill payer services, trust services, and financial counseling services. Its primary asset investment will continue to be consumer home loans, but its managerial economics will not be rooted solely in spread management or asset-liability management.

Large thrifts will expand distribution systems to provide accessibility and convenience and will concentrate on loan origination, packaging, sales, and servicing as tools to generate gross revenues. Most important-

ly, more emphasis will be placed on subsidiary service corporation development. The key to a thrift institution's succcess via diversification is not in trying to be all things to all people but rather in focusing on those industries and segments that fit an institution's particular strengths and that show promise of achieving the desired share of the market. A diversified family financial service company whose primary asset is consumer home loans would meet the charter of the savings and loan system by meeting the thrift and home financing needs of households. It could also provide a stable method of financing the housing industry which is so critical to the economic, social, and political well-being of this country. It would allow well-managed thrifts—those that understand both *planning* and *control*—the ability to reduce the inherent susceptibility of their earnings stream to interest rate risk. Thrift institutions that are patient and understand why they were created—to meet the thrift and home financing needs of households—will prosper. A successful thrift will patiently await orders from the market. It will focus its strengths to meet expressed needs and recast its balance sheet in light of this imperative.

Bank structure and competition: a general perspective

*Vergil V. Miller**

Between 1945 and 1968 the mutual fund industry grew rapidly; between 1969 and 1974 the industry experienced "hard times," and there was virtually zero growth between 1971 and 1978. While total assets of the mutual fund industry changed little during the seven years ending in 1978, assets of depository institutions rose a healthy $934 billion. Since 1978, total assets of all types of mutual funds have risen substantially, primarily because of money market funds. Inflation and high interest rates have imputed unique values to money market funds.

It may be enlightening to analyze the real impact of money market funds on the fortunes of depository institutions. Should these funds vanish tomorrow, depository institutions would not be relieved by the probable dispersion of the approximately $182 billion of money fund assets as of year-end 1981, because the approximately $71 billion in institutional investments would go into short-term securities along with about $87 billion in individual accounts.

The plight of the savings and loan industry does not stem from the slower growth it is now experiencing; its problems stem from its deteriorating earning capability due to the narrowing "spread" between the cost of lendable funds and its income stream generated from previously granted low-yielding loans. Banks are also feeling the pressures of narrowing spreads, and they view the growth of money market funds as threatening their domain. However, there is convincing evidence that the problems faced by depository institutions are not due to money market funds but to the fact that they are not able to maintain their former competitive ability to attract a lion's share of deposits because of Regulation Q.

Elimination of Regulation Q has been resisted by the savings and loan industry because a sudden repeal would force thrift institutions to operate in a competitive market environment for deposits. Only when steps are taken to solve the pressing financial crisis of the thrift industry can the Depository Institutions Deregulation Committee get on with the program of eliminating Regulation Q.

The Glass-Steagall Act is also under attack

*Mr. Miller is President of American General Capital Companies and was a university professor and administrator for 15 years.

with much attention being focused on its prohibitions. For almost two decades the nation's largest banks have sought to enter the securities business from which they have been excluded for over 100 years. Their previous experience suggests that the Glass-Steagall Act was put in place for good reason. Within three years after the McFadden Act of 1927 legitimized underwriting of corporate securities by commercial banks, they had captured over 60 percent of the market. Although this experience suggests that commercial banks tend to dominate any sector of the securities industry they are permitted to enter, it is up to the Congress to sort out the pluses and minuses in terms of public policy.

Quite properly, in my view, our society considers aspirations for legitimate growth as a virtue. And if we accept this premise, then it is appropriate and necessary for firms to pursue expansion and integration of the financial services they offer to the public.

At least five factors have contributed to the rapid rate of change experienced by the financial services industry: a) historically high levels of inflation and interest rates, b) "consumerism" fostered by savers' increasing sophistication in money matters, c) new products competing for savings, d) technological innovation, and e) a changed philosophy in government concerning competition within and among industries.

Regulatory changes will facilitate the development of "scrambled finance" under which each type of financial institution seeks entrance into the business of the others. More institutions will seek, and government will approve, the broadening of their line of financial services. The provision of services on a fee basis will be a major growth area; the resulting structure of the industry will appear more homogenized and offer customers far more choices as to where they may obtain a broad range of financial services. Hedging with futures will be a common practice for closing the "maturity gap" created by borrowing short-term funds and lending them for a longer term. Much progress in circumventing the McFadden Act has already been accomplished through banks taking advantage of the Edge Act to establish offices at distant locations to enhance international trade and through banks' strategic placement of loan production offices. Further inroads will more than likely be made in interstate banking through the use of electronic funds transfer systems and automatic teller machines located at points of sale. Commercial banks and thrift institutions will probably be allowed only limited authority to underwrite corporate securities. Brick and mortar facilities will be largely replaced by intrastate and interstate networks of ATMs.

There is little doubt that fewer institutions will be providing financial services through a greater number of outlets. The systems of financial institutions in the United States are currently unique in the world, but in the future, the differentials will gradually diminish. Those organizations whose leaders cling to the ways of the past and expect to remain dependent on "cheap money" will not share in shaping and coping with the financial services industry of the 1990s.