

NOTEWORTHY

Does Deregulation Undermine Stability?



One of the Federal Reserve's most important duties is to make sure that the nation's financial system is stable. But how should we and other bank regulators go about achieving this goal? That's a large and complicated question.

In many ways, the banking industry in the United States was shaped by the events of the 1930s. The collapse of a number of

financial institutions led to regulations that limited the activities of banks. This was meant to shelter them from risk and to prevent additional collapses. At the same time, efforts were made to protect the consumer from another wave of bank failures. In particular, the federal government began insuring deposits through the Federal Deposit Insurance Corporation.

A quick glance at the post-Depression history of the banking industry would seem to vindicate these decisions. Until recently, many of the regulations that went on the books in the 1930s were still in operation — and overall, the industry has been quite stable, with relatively few failures. But does this necessarily mean that such regulations were the best — or only — course of action? I don't think so.

In fact, research suggests that the collapse of the 1930s could have been averted — or at least would have been considerably less severe — had the regulation of the banking industry been less restrictive prior to the Depression. As the cover story in this issue of *Region Focus* discusses, branch banking has grown dramatically in the United States in the past decade. Freed from regulations that confined their business activities to specific states or geographic regions, some banks are now operating on a nearly national scale, with branches throughout the country.

At first blush, such expansion might seem like a potentially risky phenomenon. After all, the bigger an institution gets, the more it has to lose, right? At one level this is correct: The collapse of a large bank with branches in numerous areas would pose a significant problem to the nation's financial system.

But the data pose an interesting problem for proponents of regulation. Prior to the Depression, some states prohibited branch banking while others allowed it. In addition, some states already had deposit insurance programs of their own. How did the different states fare? On balance, banks in states that permitted branch banking and did not adopt deposit insurance programs performed better than banks in states with tighter regulatory environments.

Deposit insurance programs presented a moral hazard problem: Some banks got too big too fast, secure in the knowledge that there was a safety net to protect them from bad business decisions. The problem was particularly acute in heavily agricultural states, where banks loaned freely during the agricultural boom of 1914 to 1920, but faced hard times when farm goods prices began to fall. In fact, all the state deposit insurance fund systems collapsed during the 1920s.

Meanwhile, branch banking proved quite successful. As Columbia University economist Charles Calomiris has written, "States that allowed branch banking saw much lower failure rates — reflecting the unusually high survivability of branching banks — and responded well to the agricultural crisis by consolidating banks and expanding branching systems, where this was allowed."

Consider an example from the Fifth District: South Carolina. Its economy, like those of other primarily agricultural states, was hurt by the drop in farm prices during the 1920s. But its banking system stood up relatively well — as did the banking systems in most other states that permitted branch banking.

The success of branch banking may seem counterintuitive. It might appear that a bank with branches spread throughout a region is especially risky since that bank often has more to lose than a bank with just one office. But the very fact that a bank has a large and diversified portfolio actually enhances its stability. Its risk is spread over a wider pool, meaning that if business is ailing in one area, others may remain healthy.

In contrast, the more geographically concentrated a bank's depositor base and lending clientele, the more risk it faces. In such a world, if one segment of its customers is facing problems, it's likely that other parts are as well. This can put a bank under severe, and perhaps fatal, pressure — and is arguably what happened to many banks during the 1930s.

So, overall, I think that we should look at the deregulation of the banking industry and the resulting rise of interstate branch banking as a welcome occurrence. The U.S. financial system, I believe, will become more efficient over time. And for the reasons I have discussed, I think it also will become more stable. Both are healthy trends for consumers.

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