



FEDERAL RESERVE BANK OF SAN FRANCISCO
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MAJOR FORCES FOR CHANGE IN BANKING

Remarks of

John J. Balles, President

Federal Reserve Bank of San Francisco

Carter H. Golembe Associates

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Major Forces for Change in Banking

When Carter Golembe asked me to speak here tonight, he did not suggest that I would be used as an object lesson to illustrate the theme of the conference--the costs of regulation--although that thought might have crossed his mind. Rather, he suggested that I discuss, in broad-brush fashion, some of the major forces that are now affecting the banking industry, partly through Congressional and regulatory decisions, and partly through underlying technological and economic trends. You are certainly just as familiar as I am with all these developments. But since changes are coming today so fast and furiously, and since they are interrelated in so many ways, it would be useful for us to red-flag some of the major developments--to show how, as a group, they constitute a major set of forces for change.

Let me begin by quoting some rather unflattering remarks made a few years back by a long-time observer of the industry. "Banking has had a pattern of traditional services, an imposed molecular structure, and a pedestrian operating technology, none of which it could call its own. It has not innovated its service products nor shown much adaptive ingenuity in their promotion. Its competitive aggressiveness has been schizophrenic, with large sectors of the industry advocating or supporting publicly administered price ceilings for time deposits, public prohibitions against the absorption of exchange, and a variety of regulatory devices or postures that by sanction or promise dilute competitive ingenuity."

The speaker was George Mitchell, the time was 1967--and despite all the striking innovations of the intervening period, I rather imagine that Governor Mitchell would take much the same line today. The rigidity that he describes is understandable, reflecting as it does the extraordinary impact of the Great Depression and World War II on the industry. The Depression conditioned bank managements and regulators to a fear of future commitments and a strong concern for liquidity. The war and its aftermath solved for a while the problem of liquidity, but deadened the sense of initiative by providing managements with no more challenge than managing a portfolio of government securities. The industry has developed a number of innovations in the last several decades, of course, but many segments of the industry have remained burdened by the dead hand of the past.

To help understand the resultant problems we should ask just what is the business of banking? Just what ought to be the functions and powers of commercial banks in an era of sweeping changes in society? I'm not going to answer those questions in one brief after-dinner speech, but I'll try to indicate some of the changes that will affect banking's basic intermediary function, in one way or another, in the coming decades. Banks produce a number of services--handling the nation's basic means of payment, functioning as a source of credit, providing customers with low-risk assets, providing accounting services, maintaining investment portfolios for the public, and so on. But other financial and even nonfinancial institutions are operating today in many of these same areas, and banking's future will be affected by the responses of all of these institutions to the forces that are now

changing the industry's ground rules. Let's consider the challenges arising from four different directions--from computers, from bank customers, from thrift institutions, and from nonfinancial institutions--and consider also the challenge which banking itself poses to other institutions, such as the securities industry. With those factors in mind, we can better understand the policy responses arising from Congress and the regulatory agencies.

Technological Innovation

Technological innovation affects all financial institutions, but one of its most significant impacts may be in the area of bank branching. Banks in many cases have increased the size and penetration of their market areas by branching, but at the cost of higher operating expenses and diluted profits. In the past 15 years, the number of banks in the U.S. has increased by 7 percent but the number of branch offices has jumped by 170 percent--permitting the number of persons per banking office to decline from 7,500 to less than 5,000.

We now realize, however, that branching is not the only possible method of supplying convenient banking services and of improving a bank's effectiveness. Customers no longer have to travel to a banking office to make deposits, get cash or pay bills. Direct deposit of salaries and other income payments is a reality and is bound to increase. Teller machines have been developed, at less cost than branches but with comparable efficiency, to provide service to shopping areas and workplaces. Moreover, point-of-sale terminals have been developed to provide potentially spectacular operating savings.

Point-of-sale devices in shopping areas, factories, office buildings and other workplaces, when shared, entail minimal costs to financial institutions, being well within the reach of small as well as large banks in a given market area. Bank managers, in their market-planning decisions, thus are no longer limited to a bricks-and-mortar decision, but have an alternative way of reaching customers through flexible and relatively inexpensive electronic devices. This question may be moot at present, in view of the Federal court ruling that electronic terminals are equivalent to branches, and thus subject to the 48-year-old McFadden Act limiting bank branching. We may have to await a Supreme Court decision on this matter or perhaps some Congressional action--remember, Senator McIntyre has suggested that Congress take a good hard look at the McFadden Act. Meanwhile, the technology remains available to support far-reaching institutional changes in coming decades.

Customer Innovation

Consider next the impact of bank customers--especially through the consumer movement--on the reshaping of the nation's financial system. Banks and other financial institutions have to contend with more affluent and more knowledgeable customers who insist on a return on their money, and who thus draw down their demand deposits to minimal working-capital needs. Sophisticated consumers are now able to obtain high returns from various market instruments--which the Treasury and various Federal agencies are happy to supply in ample amounts--

and also from money-market funds. Aggressive consumerists meanwhile are pressing for the termination of bank-deposit interest ceilings, which range from zero on demand deposits to 7½ percent on the longer-term certificates. The response is evident in the recent actions of the Senate Banking Committee, which essentially would permit payment of interest on demand deposits at the end of next year and phase out Reg Q ceilings on time-and-savings deposits in 5½ years.

While consumers may be becoming less dependent on banks, the trend-setting banks may be becoming more dependent on consumers. Traditionally, the larger commercial banks have looked to businesses as their prime customers, but these customers over time have found the money and capital markets more attractive than the banks for the placement of funds or as sources of funds. A clientele which formerly provided a solid loan and deposit base for the banks has demonstrated less and less loyalty to its banking connections. Corporations increasingly pay for their banking services with fees rather than with holdings of deposit balances, and they tend to concentrate their loan demand in periods of credit restraint. The choice for banks in this situation is either to increase their dependence on interest-sensitive funds in order to meet corporate demands, or to avoid the pitfalls of liability management by cultivating a larger consumer deposit and loan base. "This market is comparatively stable, statistically predictable, comparatively insensitive to interest-rate changes, and potentially profitable with the help of modern electronic

processing," in Governors Mitchell's apt description. The question then becomes, how will the consumer respond to the importunings of the now-ardent banks?

Thrift Institution Innovation

The answer depends on the interaction between the rising competitive challenge from thrift institutions and the far-ranging changes (present and prospective) in the ground rules established by regulatory authorities. The institutional changes now underway are rapidly blurring the distinction between demand accounts and time-and-savings accounts--primarily of course through the development of NOW accounts, but also through the development of telephonic and other convenient methods of transferring funds out of savings accounts. The public increasingly holds its transaction balances and precautionary balances in time-and-savings accounts, with commercial banks and thrift institutions competing directly for such balances. They compete on the basis of both interest rates and levels of service, so that an account at any one of these institutions appears interchangeable to the depositor.

Consequently, we might expect the regulatory authorities to attempt to enforce roughly similar ground rules for these competing institutions; after all, that is one of the basic principles underlying the Hunt Commission's recommendations. Thus, we have several Federal Reserve actions which would help bring the banks into line with thrift-institution practices--the authorization for commercial banks to offer passbook-savings accounts to corporate customers, and

the authorization for banks to offer a bill-paying service to savings-accounts customers. Moreover, we have the Senate Banking Committee's set of proposals, which would further blur the distinction between the different types of institutions, such as by allowing the expansion of all thrift institutions into the consumer-loan and NOW-account fields. The key question, as always, is whether the thrift industry will be willing to give up its present tax arrangements and its present interest advantage on consumer deposits in return for broadened lending authority and third-party payments powers.

Technology has played an important part in the thrift-institution drive for a larger share of the consumer market. Electronic data-processing technology and the structure of the related service industry have given thrift institutions a capability to do for themselves, or through non-bank contractors, certain vital processing operations formerly done by banks. I would draw your attention only to the latest manifestation of the Hinky Dinky syndrome--the proposed Home Loan Bank switch-and-settlement center which would interconnect several California S&L's offering point-of-sale electronic funds transfers. Such data-handling systems frequently attain volumes capable of reducing dramatically the overall costs of deposit and money-transfer operations. To the extent those economies are realized by thrift institutions, their share of the consumer market should increase.

Nonfinancial Institution Innovation

But the challenge arises not just from the thrifts but from other competitors as well. Data-processing and communications firms, credit-

card companies, and national and regional retailers are also becoming involved in the payments system--an area once dominated exclusively by commercial banks, the Treasury and the Federal Reserve. These newer enterprises see the change-over in payments technology as an opportunity to enter the payments business without the operating handicap of having to use paper checks processed through commercial-bank channels. Indeed, as Governor Mitchell argues, while the banks and thrifts zealously try to limit each other's competitive effectiveness by statutory or regulatory action, they overlook the very strong challenge being launched by unregulated enterprises. The sheer volume of money transfers--over 100 million daily, by check alone--has overtaxed the banks' conventional labor-intensive technology, and has thus created an opportunity for more innovative firms to move in.

All of this is made possible by the break-up of the operating steps of moving money from payor to payee--an evolutionary process resulting from the introduction of the credit card and the removal of check processing from a backroom operation to a centralized operation. Nowadays, funds transfer, data handling, data transmission and the extension of short-term credit all can be segregated operationally. Moreover, all steps can be performed outside of the banking system--except for funds transfer, and even that can be simplified. The field offers many profitable opportunities for entrepreneurial talent, and that talent is just as likely to be found outside the banking industry as inside.

Securities Market Opportunity

Remember, though, that the growing challenge to the banks inside their own bailiwick is balanced somewhat by the growing challenge of the banks to other financial institutions. In recent years, we have seen the expanding power of bank holding companies in a number of non-bank areas. Now, with the upcoming hearings of the Securities Subcommittee of the Senate Banking Committee, we're likely to hear a great deal about the growing strength of the banks in the securities industry. Banks already underwrite Treasury securities and general-obligation municipals, and through their trust departments, they are the nation's largest investor in corporate stocks. They have become important suppliers of longer-term (as well as shorter-term) capital to business through expanded term-loan activity--and of course they are heavy lenders to the brokerage industry itself. The banks' powers may increase by default if Wall Street continues to be beset by sluggish trading volume and by the wild price competition triggered by the shift to fully negotiated commission rates. It may be too early to bury the Glass-Steagall Act, but if Wall Street proves unable to meet the nation's very heavy capital needs, the banks perforce may have to fill the gap.

But in this as in other areas, the banking industry will be affected by the changing groundrules brought into being by changing economic circumstances. Thus we have the new guidelines proposed not only by the bank regulatory authorities but also by the SEC in its role as protector of investors in bank holding companies. Under

these guidelines, large banks would have to furnish such new information as their loan-loss experience, income statements for foreign branches, maturity breakdowns for various loans, and detailed interest-rate data for security holdings. The guidelines represent a difficult compromise between investors' rights and bank customers' rights. In developing them, we have had to weigh carefully the type and form of disclosure imposed on banks, so that we don't undermine the banks' willingness to assume risk--and also don't erode the confidence of depositors, which after all is a key determinant of the banks' ability to attract the funds needed to finance future lending activities.

Concluding Remarks

What conclusions can we draw from this discussion? Above all, bankers should remember that we live in Earthquake Country, affected not only by shifting regulations but also by the shifting of the very ground beneath the industry's feet. Technological change is a constantly disturbing element, posing a major change to such established practices as bank branching. The demands of a more affluent and more sophisticated consumer are another seismic force. Thrift institutions and (increasingly) nonfinancial institutions, by their rapid adaptation to this new environment, provide a serious challenge in many aspects of the banking business. But banks themselves have the power to expand--for instance, in the securities industry--by proper adaptation to institutional and technological change.

To deal with these far-reaching developments, I would like to suggest several principles, in line with the proposals made several

years ago to the Hunt Commission by a Special ABA Committee which I chaired. Basically, our committee argued that 1) maximum reliance should be placed upon free-market forces to assure an innovative financial system; 2) regulatory processes should be reviewed continually to ensure that each regulation is justified and that its administration is not unnecessarily restrictive; 3) public-policy measures for financing the nation's social priorities should provide incentives to all lenders, and should not subsidize only certain specialized institutions; and 4) the ground rules for competition among financial institutions should be equitable, with no substantial differences limiting the ability of these institutions to compete with one another.

I submit that these principles have held up well, and that they provide a basis for developing an industry-wide position on the issues first crystallized by the Hunt Commission. But it seems essential that bankers close their ranks and work to develop a unified position on these crucial issues. If they don't, they will only lose their markets, in piecemeal fashion, to other institutions.

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