For release on
Friday, October 25, 1968
at 12 Noon EDT

Getting the Most Out of the Banking System in the Seventies

Remarks of George W. Mitchell

Member, Board of Governors of the Federal Reserve System

at the

Annual Homecoming Seminar and Luncheon

Sponsored by the School of Business Administration and
the Alumni Board of Managers of Temple University

Philadelphia, Pennsylvania

October 25, 1968

Getting the Most Out of the Banking System in the Seventies

This is about that time in the decade when luncheon speakers are licensed to characterize the upcoming decennium. They can predict with alarm or confidence, try to stretch your imagination, or simply coin a phrase like the "Soaring Sixties"--a characterization that stuck pretty well over the past ten years. And one, incidentally, that turned out to be a far better one-word forecast than most business prophets can achieve with a lot more words and a lot less lead time. Just how good it was is evident from the National Bureau's records of recession and expansion, which show we've had only one setback in the decade. It was early--May 1960 to February 1961 and of nine month's duration. The prediction is all the more amazing in light of the past record the forecaster had to go by--recessions in 1949, 1953-54, and 1957-58, aggregating 33 months of contraction in all.

I have no idea what adjective will get popular acceptance as appropriate for the Seventies, nor how perceptive it may turn out to have been. But whoever thought of the "Soaring Sixties" was doing more than predicting--he was expressing a widely held hope and goal for those years. It was for some sort of economic millenium--perhaps a recessionless capitalistic society. In a real sense we achieved it; that is, if the business cycle isn't really dead it's dead enough to be a feeble challenge to public policy in the

Seventies. In slaying this particular dragon we found that living with prosperity has dragons, or dragon seeds, of a different sort. For even though we appear to have sufficient skill with fiscal and monetary tools to avoid recession, sustained expansion does not mean that acceptable social conditions will accompany it, that our international economic relationships will be in equilibrium, nor that the next generation will accept the product or the price they think we've paid for it.

It seems to me likely, therefore, that we may, in the Seventies, be devoting more attention to the structure of our society and its institutions and less to managing aggregative demand. For example, in the fiscal field far more attention would be given to tax reform and the character of Government's expenditure programs while the aggregative effect would be managed in the interest of sustained expansion more or less as a matter of course. It is even conceivable that structural import of monetary action might, as financial linkages become better understood, influence the use of the alternative tools of monetary management within the constraints of the needed aggregative effect.

If the Seventies turn out to be a structuralist era we should find a great deal of attention given to our banking structure. Some would say it needs it; that the industry as a whole or at least significant sectors, geographical and otherwise, are backward looking. There is certainly a large element of truth in the assertion but it no longer fits the attitude of the Nation's leading bankers. Most of them, whether affiliated with large or small banks, are chafing more and more at regulatory constraints, are embracing the technological revolution in data processing and looking for ways to be a growth firm and expand their earning potential. The Saxon liberalizations of the early Sixties are just one manifestation of the underlying forces in the industry aimed at broadening its scope of operation.

Banking has not been doing badly either if we gauge its performance by its share of funds supplied to credit markets. In the Fifties this share was 23 per cent, a level somewhat adversely affected by several years of monetary restraint (banking's share of the market is reduced in periods of tight money). In the Sixties it averaged 34 per cent. Thus, in the Sixties, banks have increased their share of the credit market by nearly 50 per cent. Other depository institutions' share was up only 10 per cent. Banks were successful in this competitive surge largely because of their aggressive exploitation of new time deposit forms, such as the negotiable certificate of deposit and their use of other liability instruments such as federal funds and Euro dollars.

Despite these accomplishments some aggressive bank managements are far from satisfied. They do not want to be chained to the growth rates of the immediate community they serve, whether it be a central city, a metropolitan area or a State. Nor are they content with a growth rate matching that of the Nation or their toughest competitor. The emergence of such growth goals is, of course, not new to American business where innovative technology and conglomerates can operate, but, it is far from "old hat" in banking.

How far should public policy go in accommodating these ambitions? What risks are involved in relaxing statutory confinement of banks? What gain in lower prices for credit and better services might ensue?

It seems to me that the general guidelines for policy are clear--far clearer than the means of implementing them. Let me state them as I see them. The initial choice is in the mix of the competition and regulation used to achieve public service and efficiency objectives. I opt for less regulation and more competition because I think it abundantly clear that banks cannot, given present-day conditions and technology, be insulated from non-regulated nonbank competition, and they face a lot of it. They cannot even be effectively insulated from regulated nonbank competition.

If regulators cannot protect banks from competitive inroads on their markets through chartering policies that deny new entry in "over banked" areas they should relax constraints on banking's competitive efforts if they expect this industry to attract capital and management talent.

Greater reliance on competition means broadening bankings' market participation, easing chartering restrictions, repeal of home office protection clauses found in many States and the disapproval of anti-competitive mergers or holding company affiliations. It means banks should be able to, or even encouraged to, extend their markets geographically or through their specialties providing new potential customers for them, with new banking alternatives. While State lines have become Berlin walls so far as branching is concerned, there is no economic or institutional reason for not negotiating interstate compacts to enrich the banking alternatives for citizens who live in metropolitan areas extending into two or more States.

In practice, all of this involves intense controversy within the banking system itself reminiscent of the chain store controversy of the 1930's. It would be unfortunate to have a replication of that stance against the trend of the times especially since there turned out to be a role for both kinds of stores just as there are, undoubtedly, natural sustaining advantages for both unit and branching types of banks in our widely diversified economy and environment.

After all, well over 7,000 banks in the Nation are located in one-bank towns outside of metropolitan areas. Three-fourths of our Nation's banks are in towns where there are no more than two banks. Most of these communities are small--half have populations of less than 1,000, only 10 per cent have populations of over 5,000.

These institutions are not about to be engulfed by outside branching systems because of local loyalties and because the economics of expansion call for investment in faster growing and more expansive environments than exist in most isolated rural communities.

Perhaps the issue will become moot in the Seventies anyway and banks will not need to care what the prohibitions against branching are because they will have no need for anything more than salesmen, production offices or some other service facility not concerned with deposits or withdrawals.

If I had to bet on it I would say the mail box, the telephone, the cash/credit card and electronic circuitry would become the vehicles for handling deposits, transfers and currency withdrawals in the Seventies.

Electronic transfer and accounting is here--in England last week the electronic national Giro began operation with an ad "Don't Pay Any More Bills.....Giro Them." A month ago the Federal Reserve System announced a contract with Marshall Industries to install a central communications switch which will link computers at Reserve System offices. This system will have a capacity of 12 times the present wire network which handles about 9,000 items aggregating several billion dollars daily.

As was pointed out in the Board's press release,

> "The automation of deposit transfers between and within Federal Reserve offices will open the way for a completely electronic transfer system for a large portion of the country's money movements. Given a Federal Reserve wire system with adequate capacity to respond immediately, member banks should find it desirable to automate their own communications with the Federal Reserve Bank or Branch

> which serves them. This would enable them to transfer funds to or from any other member bank on a "computer-to-computer" basis. Thus, they would have the capacity to move money, at the direction of their customers, to or from any customer of any other member bank, wherever located."

We are in a period of transition into an electronic money system. It may be operated on a credit or debit basis. On a credit basis the individual will direct his bank to make a transfer from his account to that of his landlord or a department store. This is the method used in Giro systems including the recently inaugurated English Giro. In a debit-type transfer, the individual sends a check to his landlord or a department store which authorizes the charging of his account when the check is presented to the bank on which the check was written. Either system can be operated with electronic facilities but Giro is more certain and economical. The debit system creates an awkward problem not faced by Giro, namely of truncating the check flow, for obviously the check cannot trail along after the electronic processing without negating electronic efficiencies.

In some quarters it is still argued that electronic settlement cannot replace check flows but it was also argued in the late Forties that the airplane would not displace the Pullman car. The paper mountain is getting too big to move day after day and those who question the necessity of electronic processing might reflect on the reason for closing the stock exchanges one day each week.

I turn now to another manifestation of the 1968 growth-mindedness among bankers, the recent flare up of interest in the one-bank holding company. One-bank holding companies are not new. Until just recently there were about 650 such corporations with a great variety of financial and non-financial affiliations. So far as I am aware, the experience and performance of banks in these conglomerates has not been intensively studied from the standpoint of implication of such linkages for public policy objectives.

From the beginning, the Board's position has been that the prohibitions in the Bank Holding Company Act against bank holding companies engaging in nonbanking activities should apply to one-bank holding companies. Chairman Martin testified to that effect during hearings on the original Act in 1955. And in 1958, in a special report to Congress recommending a number of changes in the Act, the Board repeated its recommendation that one-bank holding companies be covered, with the following observations:

> "*** ....if it is contrary to the public interest for banking and nonbanking businesses to be under the same control, the principle is applicable whether a company controls one bank or a hundred banks, and the possibility of abuses from such common control is the same. In fact, if a company controls only 1 large bank, that company's interests in extensive nonbanking businesses could lead to abuses even more serious than if the company controlled 2 or more very small banks....."

Congress rejected the Board's advice in 1956 and took no action on the Board's later recommendations for amendments until 1965, when the House passed a bill amending the Holding

Company Act. The bill as introduced had a more limited objective, but Representative Bennett of Florida offered several amendments on the floor of the House to carry out Board recommendations, including the one-bank amendment, and the House agreed. When the Senate took up this legislation in 1966, it eliminated the one-bank holding company amendment, again rejecting the Board's argument for the amendment as presented by Chairman Martin. In testimony in 1966 before the Senate Banking and Currency Committee, Mr. Martin again urged that coverage of one-bank holding companies was needed to carry out the Act's objective of prohibiting combination of banking and nonbanking businesses through holding companies. His testimony included the following quotation from the Senate Committee's report on the original Act:

> "*** bank holding companies should confine their activities to the control and management of banks and activities closely related to banking. They should not combine management and control of banking activities with management and control of nonbanking activities. The divestment requirements in this bill are designed to remove the danger that a bank holding company might misuse or abuse the resources of a bank it controls in order to gain an advantage in the operation of the nonbanking activities it controls." (S. Rept. No. 1095, 84th Cong., 1st Sess., pp. 13-14)

The Senate committee report on the 1966 legislation included the following comments regarding the one-bank holding company amendment:

> "After considering all of this testimony, the committee came to the conclusion that there was no substantial evidence of abuses occurring in one-bank holding companies. Furthermore, the committee received much testimony to the effect

> that repeal of the exemption would make it more difficult for individuals to continue to hold or to form small independent banks. The repeal of the exemption would, therefore, be likely to result in causing the forced sale of large numbers of banks and in a diminution of competition rather than in an increase of competition. Consequently, the committee decided not to adopt this proposal."

Our present knowledge, or any that we might glean, from the experience of well established 1BHC's, is not likely to go far toward settling the issue of an appropriate role of the new type 1BHC in the future. It may be the same shoe but it's on the other foot. Banks that have been captives of nonbank corporations or conglomerates are in a significantly different position from banks who have acquired through their holding company nonbank captives--it's the difference between being a captor or a captive.

Congressional leaders have already indicated an interest in the rapid spread of the new type 1BHC. Presumably hearings will be held in 1969. I would expect them to focus on anti-competitive implications, possible undue concentration of economic power, and the potential skewing of banking services and resources to affiliated interests.

If a 1BHC acquires nonfinancial businesses, anti-competitive consequences are likely to be slight but if big banks and large sized industrial or service firms are affiliated undue concentration of power might ensue or the public's interest in maintaining proper access to the Nation's banking resources might be impaired.

If a 1BHC acquired a banking-related-type business--say a savings and loan association or a finance company--which was located in the same geographic market area as the bank anti-competitive considerations would probably be of greatest concern.

A statutory line of acceptable affiliation with other businesses has been well established for banks and for two-bank holding companies; there may be no reason for 1BHC's of any type to be treated differently. If we pierce the holding company veil, should not banks have the same guidelines for expansion as two-bank holding companies or one-bank holding companies with captive banks, or one-bank holding companies with captor banks? Probably we need a re-examination of expansion guidelines for banking institutions regardless of, as well as in light of, the form of their corporate organization.

If we have such a re-examination we will need to face the fact that financial intermediaries, particularly banks, are _sui generis_ in their leverage, public supervision, government insurance and tax treatment characteristics. How far should we go in asserting that these characteristics of necessity require limitations on the growth or diversification of the banking industry or units within it? A wise resolution to this problem may well have much to do with the suitability of the bank structure to the economy of the Seventies.

I do not want to conclude my remarks without brief mention of other structural changes that will be confronting banking in the Seventies. Most of them are of more narrow technical interest to bankers. The scope of international operations is one such; of significance, it is true, to larger banks but to a steadily growing number of them. A whole series of structural problems for banking is related to developing more stability in liquidity instruments and arrangements.

The U.S. financial system in the postwar years has been moving toward greater and greater liquidity assurances to the customer of banks and other depository institutions. This trend has brought about great advantages for banks' customers, is profitable for the banks themselves and even satisfies, on occasion, ambitious growth goals. But unless these liquidity commitments have a predictable incidence or frequency they must be systematically hedged or covered in some way. As our financial system becomes more and more finely tuned (the trend of recent years) the greater its exposure to disorderly reactions to unexpected liquidity demands.

Demand deposits, for example, are usually thought of as the ultimate of liquidity but since demand balances have become almost entirely associated with the regular pattern of transactions needs their liquidity element has been significantly attenuated. Individuals and corporations who manage their accounts well convert their liquidity resources into other forms--short-dated debt or time deposits of some form or another. In some one of these forms it is just as satisfactory as a demand balance.

On the other side, bankers generally have to be ready for unanticipated liquidity demands either through the management of their deposit and asset structures or by maintenance of their borrowing capacity, whether at the central bank in Federal funds or in Euro-dollar market. It would strengthen the viability of the entire system if bank assets and liabilities were shiftable into and out of the market meeting the market's price and term discipline or incentive. Much is evolving along these lines but a greater awareness of the importance of continuing progress is needed.

Some of you may be surprised that a central banker would stress the necessity of a wealth of liquidity sources because monetary restraint is accompanied by--in fact, in essence, is--a contraction of liquidity and monetary ease--an expansion of liquidity.

The answer lies not in thwarting monetary intent but smoothing its course and lessening its discontinuities. Increasing institutional capacities to modify monetary restraint is perfectly consistent with effective monetary control so long as the escape hatches have steadily rising costs and increasingly onerous terms. The more pervasively and gradually these come into play the more effectively and confidently we can use monetary tools.

I have tried to give you, today, an agenda of sorts for structural reforms in banking for the Seventies. It probably incorporates more trends in being than it perceives or forecasts goals which will emerge. I do not pretend to have the foresight of the author of the phrase "the Soaring Sixties." But I do feel fairly sure that if we ignore this agenda's problems we'll start the Eighties disadvantaged by an obsolete banking system.