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THE ROLE OF COMMERCIAL BANKS IN FINANCIAL INTERMEDIATION

by

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Last week the flexible interest rate authority granted by Congress a year ago to the Federal supervisory agencies of financial institutions was extended for one year. The Federal Reserve, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board were again given broadened powers to vary interest or dividend ceilings on deposits or share accounts in response to changes in economic conditions.

As demonstrated over the past year, the added authority was used effectively to restrain excessive rate competition between depositary-type institutions and thereby check further escalation of rates paid by these institutions. The law also permits the ceilings to be placed on a standby basis at the discretion of the supervisory agencies.

Thus, the agencies at the Federal level that supervise commercial banks, mutual savings banks, and savings and loan associations have the necessary flexibility to deal with rate developments affecting claims on financial intermediaries for another year. Because the economic situation is constantly in a state of flux, however, it is most desirable that serious consideration be given to making this authority permanent. Extension on a year-to-year basis constricts the options available to both the supervisors and to the institutions they supervise.

The prospects at this time are for a resumption of vigorous economic growth later this year. Although interest rates are liable to remain high, with adequate fiscal and monetary provisions, there is little probability of a repetition of last year's intensive rate competition and money "squeeze." Another episode in our long and eventful financial history has passed.

Although it did not seem so at the time, last year's experience reflected to a great extent the unforeseen coincidence of a number of short-run, transitory phenomena. It was complicated, in addition, by the simultaneous introduction of innovations in the savings market and by developments affecting the institutional participants themselves and their relationships with one another. There were also a number of basic but largely unrecognized changes that had taken place over a period of time in the market for savings, in the financial sector as a whole, and in the economy in general.

Today, I should like to abstract from the present and from the immediate past and look beyond to the future. Specifically, I should like to consider the role that commercial banks can or should play in financial intermediation and pose some questions about the nature and shape of financial intermediaries in the future.

At the end of World War II, commercial banks were under little or no pressure to seek out "new" money. The ample liquidity position of the banks tended to isolate them from the marketplace, and this isolation was reinforced by a conservative view of appropriate banking activities. Thus, the substantial pent-up demand for residential mortgage financing bypassed the commercial banks and was met principally by an expanding and aggressive savings and loan industry. The savings and loan associations were able to attract funds to finance the postwar housing boom by offering relatively high rates of return on share accounts. As a result, the savings and loan industry grew faster than commercial banks.

In the process of seeking ways to employ its available funds, which were largely in the form of demand deposits, banks began to look for new but mainly short-term investment outlets. As a consequence, banks expanded their activities in mortgage and consumer financing and other services, increased holdings of tax exempts, raised their rates on time and savings deposits, and subsequently moved into the money market to seek the idle balances of business corporations and other large savers through the negotiable certificate of deposit. As the accumulated liquidity of banks was absorbed, the need to attract additional funds mounted, while credit demands increased. Banks increasingly began to feel the impact of the marketplace--in the competition for funds and in the competition for customers. By the mid-1960's, commercial banks had generally regained their leadership over other financial intermediaries.

The preceding account is a capsule and overly simplified version of the complex developments that occurred in the savings market in the postwar period. But it serves to point up the important role of depositary-type institutions in financial intermediation. It also serves to illustrate the shifts that can take place in the relative importance of the different types of financial intermediaries over time as a result of differences in aggressiveness, in willingness to assume the initiative, in the ability to anticipate future demands for either financial services or savings instruments, and in statutory structure or powers.

The whole postwar period therefore provides a most useful lesson for banks--a lesson which can be most profitable for banks. The experience of the past year and a half can be misleading as a portent of things to come. The situation was unique in many respects and cannot reasonably be expected to repeat itself. But some features of these months will remain--continued high levels of employment and output, a generally higher interest rate structure, continued competition for new savings, the greater sensitivity of savers to interest rate differentials, and the wide variety of investment outlets available to the saver.

Keeping these features as well as the whole postwar experience in mind, banks should recognize that their ability to remain competitive in the savings and credit markets and their ability to continue to grow depends on their responsiveness to changes in the markets for savings and for credit. Bank responsiveness to the realities of the market-place enabled them to tap the sizable idle balances held by business. Introduction of consumer-type smaller denomination savings instruments enabled banks to attract or retain interest-sensitive funds of the small saver. The availability of--and accessibility to--other competing investment outlets may necessitate the development of other savings instruments tailored to the particular needs and preferences--whether denominations, maturities, or other characteristics--of either the large or the small saver. Direct investments in market securities last year provide a good example of the pull that other investments can exert on the individual saver.

I might digress here for a moment to point out also that the concept of "saving" itself is changing. When we speak of "savings" in an economic sense, we refer to that part of current income that is not spent. In an institutional sense, savings--as evidenced by a savings instrument of some type--may now be less the kind of "rainy day, emergency" fund of the past and more just one of many alternative investments available. There is evidence, that demand balances of many individuals and corporations have been reduced to minimum levels in order to take advantage of more attractive investment opportunities, including time and savings deposits in banks or share accounts. To the extent that demand balances are shifting into time and savings accounts, bank costs are increasing without a corresponding net deposit inflow. The changing nature of "savings" is thus one of the variables that must be kept in mind in looking at the savings market of the future.

Since financial intermediation consists of the channeling of the savings of many into productive use, the mobilization of these funds is of primary importance. At the same time, the other side of the coin cannot be neglected--the profitable employment of these funds and their allocation to the most productive use. As a supplier of credit, commercial banks again face formidable competition. Many business firms, for example, have access to the commercial paper and securities markets as well as to banks to meet their financing requirements. Nonbank financial intermediaries may be able to service business requirements more satisfactorily--or new institutions can be established to fill a gap in available facilities. The smaller borrower in turn may be diverted to other credit suppliers--although his alternatives tend to be more restricted in number and confined by geographical considerations. All borrowers, in fact, have some access to alternative sources of credit. Therefore, in order to retain their customer base, banks and other lenders must be willing to offer new services. This has been a factor in the decision of many banks to participate in bank credit card plans.

Because banks constitute an integral part of the financial mechanism, they should, in addition, always remain conscious of their responsibilities to the public as well as to the private sector of the economy. The social needs of the nation have grown with the increasing urbanization of our society. Financial institutions have played an important part in the development of this nation. They should not by default fail to participate in the solution of its most pressing problems. These problems are not always clearly defined nor their solutions definitive, but bank management can surely make a major contribution. It is not surprising that satisfying the needs of society will usually prove profitable also to the individual enterprise over the longer run.

Banks must remain ever responsive to the environment in which they operate in order to retain and expand their role as financial intermediaries. If banks are lax in discharging this function, their major problem could be not disintermediation--or, for banks, the diversion of funds <u>from</u> banks into the market--but what might be called "nonintermediation"--or complete circumvention of banks or other financial intermediaries by direct investment in market instruments.

Financial intermediation is an essential ingredient of a modern society and a function that has been efficiently and effectively performed by banks. With the growth in personal saving from a postwar low of $7 billion to an annual rate of more than $37 billion in the first half of 1967, the magnitude of the task has obviously increased. Internal cash flows now supply a smaller share of corporate financing needs than in the last year or two, for example, so that the task of matching up savers with users of funds has assumed major proportions.

In order to meet this challenge, banks must grow. In the past, a large part of the expansion of the commercial banking industry was attributable to increases in demand balances. But, as individuals and business learned to make more efficient use of their working balances, the growth in demand deposits slowed. As a consequence, many banks have had to place greater reliance on time money as a source of deposit growth.

The increasing importance of time deposits in a bank's deposit mix can have important implications for a bank's competitive position and for its profitability. In the short-run and over the past year or two, the smaller commercial banks with their traditionally larger proportion of time money found themselves in a stronger competitive position than the large banks. For the most part, their time money--mainly in the form of regular passbook savings accounts--tended to be more stable and less interest-sensitive than balances at larger banks and in major financial centers. The rate on passbook savings accounts, moreover, was significantly lower. The large banks, on the other hand, had to compete at high rates with the money and capital markets for the more volatile and mobile funds.

Over the longer run, larger banks may be better able to maintain their market position because of a greater ability to compete effectively in the broad market for savings through a wider variety of instruments and the capacity to offer a greater range of banking services to the public. The smaller commercial bank can still compete successfully, nevertheless, limited only by the capabilities and imagination of management. It must be recognized, in any event, that the size of an institution may have a significant bearing on the form which financial intermediation takes.

The ability of commercial banks to compete in the future and thus participate as effective financial intermediaries is also dependent on the rates offered for savings. For banks, passbook savings are the lowest cost time money at the present time but are a rapidly declining share of total time and savings deposits. The spread between passbook savings accounts and other small denomination time money at banks is now about 1 percent. Is a differential justified? Should the rate on passbook savings be higher? The rate spread has been a factor in the slower growth in savings accounts. On the other hand, the regular passbook savings account is a familiar instrument to the small saver and offers the advantages of security and relatively ready access to cash. But I pose this question, nevertheless, to point up some of the unresolved issues presented by the existence of a differential.

Should holders of passbook savings accounts, for instance, receive a smaller return on their savings than other time deposit holders in the same institution? Is there a basic economic difference between passbook savings and other time money? Or, should additional savings instruments be developed to narrow the differentials between types of instruments and minimize switching or to provide the small saver with a wider range of choice within his own institution? There is probably a point beyond which any widening of the rate differential against passbook savings would produce a significant shifting of funds.

The issue of rate differentials on time money at banks is also relevant to the rate differentials maintained between the claims of different types of financial intermediaries. In the past, certain minimum rate spreads were considered essential to protect competitive positions and also give recognition to differences in the function--whether economic or social--of various financial intermediaries. The specialized savings institutions have on this basis justified the maintenance of a differential rate of return on their share accounts over the rate offered by commercial banks.

As in many other sectors of the financial markets, however--notably in the movement of international capital, the traditional differentials may no longer be economically valid. Capital movements, for instance, have been taking place with the interest rate differential at less than the half percentage point that was considered an effective barrier to capital mobility between national markets. On the domestic financial market, it may be true that present differential rates on claims on financial intermediaries are also no longer realistic--not only on the grounds that funds can be diverted on the basis of rate differentials narrower than previously thought but that the maintenance of a differential may possibly not be economically justifiable at all! The presence of increasingly sophisticated savers, moreover, makes the maintenance of obsolete or essentially artificial rate differentials both difficult and unsupportable.

Related to the question of rate differentials is the nature of the financial intermediary of the future. During periods of strong demand for credit, such as we experienced last year, the greater diversification of commercial banks in both their asset and liability structure enabled them to compete more effectively than nonbank financial intermediaries in the savings market. Strengthening of the nonbank financial institutions' competitive position through greater diversification of their liabilities and/or their assets might therefore be considered. The development of the future in the savings market could well be financial supermarkets, which would evolve as existing financial intermediaries "merge toward the center." A quick glance at the balance sheets of banks and other financial intermediaries reveals quite clearly that the composition of both their assets and liabilities have been changing, with the result that the dissimilarities are becoming much less marked.

This "merging toward the center" may not be the final outcome, but it seems reasonable to consider movement in this direction as a logical extension of present trends. Or, if not, our consideration of this possibility encourages us to take a broader look at what the future might hold.

It is imperative that we look at--and to-- the future at the same time that we are contending with the problems of the present. Otherwise, we may find banks losing their pre-eminent and hard-won role as the leading financial intermediaries in the savings market.