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Remarks by

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I want to discuss with you briefly this evening some of the problems and challenges that the commercial banking industry is presently facing and will continue to face in the years ahead.

Developments in financial markets are affecting in major ways the conduct of day-to-day bank operations, the nature of competition between banks and other financial institutions, the sources of funds to borrowers, and the terms and conditions on which a wide range of financial services are provided to the public.

These developments may be contributing to a sense of frustration among commercial bankers. One of my friends in the industry recently said to me, "Why should I keep my bank charter? Wouldn't I be better off without it?"

Current trends in financial markets are, I believe, seen in somewhat better perspective by looking back at what has been happening to banking over the past three decades, and by considering how commercial banks have fared in a financial world in which innovation has been the order of the day.

Thirty years ago, commercial banks hung out a shingle that said, "We accept deposits," and took whatever deposit flows resulted. There was precious little competition between commercial banks and thrift institutions, and almost none at all between bank deposits and market securities. Markets for credit were relatively compartmentalized by type of credit instrument and geographic location of lender and borrower. When a borrower's traditional source of credit dried up, he had few alternatives to turn to.

The rise in interest rates that commenced in 1951, and has continued ever since, caused individuals and businesses to begin searching for better ways to protect financial asset holdings against loss of real purchasing power. As time went on, they became more and more sophisticated in financial asset management and increasingly sensitive to differential rates of return on financial assets.

Banks and other financial institutions responded to these developments by creating new financial instruments and opening new markets--often as a means of getting around deposit rate ceilings or other regulatory constraints. The relaxation of regulations itself contributed to the innovational process. So, too, did the application in financial markets of technological

advances in the fields of computers and communication, which gave rise to automated accounting systems, computer-based cash management models, and wire transfers of funds.

The new instruments and markets that have been created are so familiar to all of you that I need not name them. Let me simply remind you that some of the new financial assets are close substitutes for money; others are not. Some are issued by banks; others by nonbank depository institutions; others by nondepository financial institutions, and still others by nonfinancial firms. The financial investor now has an enormous menu of assets to choose from and a large and growing array of chefs to prepare the financial repast.

At banks, management of liabilities took its place alongside investment portfolio and commercial lending policies as a critically important element of a bank's overall financial strategy. Liability management increased enormously the capacity of individual institutions to control their size and to extend credit to potential borrowers. It also changed drastically the source of liquidity to individual depository institutions, which previously had been liquid debt instruments issued by someone else-- often the Treasury. Now, the principle source of liquidity is the ability of a bank to sell its own debt instruments in the market.

Increasingly, banks and thrift institutions have become more alike, and there has also been a gradual blurring of the distinctions between financial and nonfinancial corporations as the latter entered the financial service industry. This expansion in the number of effective suppliers has increased competitive pressures even in the more isolated markets.

Competition has also intensified across national boundaries. Foreign banks have entered the U.S. in volume, and U.S. banks have made similar inroads abroad. Capital has begun to flow much more freely in international markets--to both public and private borrowers--with the result that the geographic location of real economic activity and the financial transactions related to it have become less closely associated. And as the share of exports and imports has risen in GNP, U.S. banks have become more heavily engaged in the financing of international trade.

Interest rates have become more volatile in recent years, and this, too, has spawned new practices and markets. Banks and other lenders have sought to protect themselves from interest rate risk exposure by moving heavily to floating-rate loans. Futures markets for financial instruments are proliferating rapidly.

The innovational process that began thirty years ago is still sweeping through financial markets. It cannot be halted. I would hazard a guess that the structure of financial markets, practices, and institutions will change as much in the next three decades as it has in the past thirty years. Technological change will continue to provide new applications in the financial field. Moreover, the effects of past innovations are still far from complete. For example, electronic transfer of funds has reached only a small fraction of its potential. EFT will surely play a substantially larger role in payments transfers in years to come. More importantly, the increased competition that banks are facing from the incursion into banking by nondepository financial institutions, and even by nonfinancial corporations, still has some distance to go, if developments of the past few months are any indication.

Brokerage houses are establishing links with banks that offer opportunities to attract funds that have not yet been fully exploited. Moreover, it would take very little for some of our large, nationwide retailers to become merchant-financial conglomerates. For example, one large retail firm has a nationwide EFT system, a stock S&L subsidiary in California, a credit card with over 20 million customers, an on-line POS system,

arrangements for clearing and settling third party payments, a full-line insurance subsidiary, a nationwide network of over a thousand offices, and ready access to the commercial paper market. If interstate branching were permitted for S&L's, that firm would have an opportunity to increase the financial counterpart of its operation enormously. In fact, the recently announced proposal of the FHLBB to permit interstate deployment of EFT terminals would give its S&L subsidiary 1,000 EFT locations and the ability to conduct financial transactions at every check-out station with almost the flip of a switch.

These potential developments in financial markets are not a new phenomenon. On the contrary, they are merely a logical extension of trends underway throughout most of the postwar period. We can therefore judge how commercial banks might fare in the emerging competitive environment by seeing how well they have adapted to change in the past.

Consider, first, the share of credit supplied to all nonfinancial borrowers by the commercial banking system. The banking system's share of total credit flows was 26 percent during the past five years. This was a little lower than the 28 percent share recorded in the first five years of the 1970's, and lower still than the 31 percent share that prevailed in the 1960's.

But it is well above the 19 to 20 percent share of the total that prevailed in the 1950's, when the innovations we have been discussing got underway. Perhaps the biggest single factor in the ability of the banking system to increase its share of total credit supplied since the 1950's has been the added funds for lending obtained by commercial banks through development of markets for negotiable CD's.

The share of the household savings flow captured by commercial banks follows a broadly similar pattern. Increased holdings of currency and commercial bank deposits over the past five years account for 34 percent of the increase in total holdings of currency, deposits at all depository institutions, money market fund shares and credit market instruments by the household and nonprofit sector. This compares with 39 percent in the first half of the 1970's and 43 percent in the 1960's. Again, however, the share in the past five years is substantially above the 28 percent figure of the decade of the 1950's.

Banks are not only obtaining a bigger piece of the action than they did in the 1950's, they are also putting the funds to profitable uses. In the 1950's, the net income of all insured commercial banks was about 0.63 percent of total assets. That ratio moved up to .75 percent in the 1960's, and to .81 percent

in the 1970's. Since bank capital has risen somewhat less rapidly than assets, the ratio of net income to equity has risen still more. In fact during the past five years the ratio of net income to equity at all insured commercial banks was more than 50 percent above its level in the first five years of the 1950's.

You might well argue that these figures do not tell the whole story, and that a more careful look at the data would uncover evidence of slippage in the relative position of commercial banks in one or another areas of the financial system. Indeed, there has been some slippage in recent years, particularly relative to the 1960's. Moreover, some of the increase in earnings probably reflects additional risk-taking. But the record of the past 30 years does indicate that banks have done quite well in a world of rapid financial innovation, increasing competition, and advancing technology. I see no reason why that should not continue.

Of course, the rewards will be greatest for those bank managers who can adapt most readily to a changing environment. Banks will have to learn how to price their deposit services in a world in which, ultimately, there will be no ceiling rates of interest on time and savings deposits. They will need to tailor their liabilities to meet the demands of highly sophisticated and

sensitive deposit customers--the small depositors as well as the large ones. Unbundling of bank services (a trend that is already underway) will probably continue, and explicit pricing of individual banking services will become more common. The way customer relationships are valued will therefore change. A premium will be placed on accurate determination of accounting and service costs and on the development of profitable pricing strategies. There will clearly be a need to stay abreast of technological developments that help to reduce costs and to provide better services to bank customers.

Borrowers will, I suspect, continually press for absorption by lenders of some of the risk of interest rate fluctuations. After all, borrowers don't like the uncertainty of volatile interest rates any more than lenders do. Providing adequate funding for longer-term customer projects, while maintaining profit margins over the interest rate cycle, will be a central portfolio management problem for banks. It will be particularly critical to avoid the temptation to speculate aggressively on the course of interest rates, a temptation that has brought grief to more than a few financial institutions in recent years.

If commercial banks are to maintain their position in the markets for financial services, they and their competitors must play the game on a relatively level playing field with respect to rates paid, reserve requirements and the geographical scope of banking activities. The Monetary Control Act of 1980 took an important step in this direction, but it still left some things to be done. The ultimate goal should be to insure that competition takes place on the basis of price and quality of services rather than by exploiting regulatory advantages or disadvantages. Let me say a few words on this score, reminding you that I am expressing personal views and not those of the Board of Governors.

The question is often asked whether cash management accounts, shares of money market mutual funds, and similar substitutes for bank deposits pose a significant problem for the monetary control. Today, the answer to that question is, I think, no. The volume of cash management accounts is still quite low. Moreover, available evidence suggests that average turnover rates for money market mutual fund shares are very low. In this respect, money market fund shares are more like passbook savings accounts than checking deposits.

New financial assets that could potentially be used for transactions purposes are, however, proliferating at a rapid pace. It would therefore seem to me useful if the Federal Reserve had the power to define as deposits for purposes of Regulations D and Q any financial asset that is properly classified as a transactions balance. Such a step seems to me important for reasons of equity as well as for purposes of monetary control.

Generally speaking, however, public policy should not seek to close loopholes by extending regulation to the offending instrument or institution. History clearly indicates that such a course of policy only perpetuates the basic problem and creates further opportunities for other unregulated firms. The better solution to deal with competitive inequities in financial markets is gradual, but steady, deregulation.

Let me close by emphasizing the importance of moving gradually toward greater freedom for you in the commercial banking industry to compete with your rivals in the provision of financial services. It seems to me obvious, as I'm sure it must to all of you, that our thrift industry is under intense earnings pressure at the moment and will remain so until interest rates come down significantly. A worsening of this problem could have serious consequences for thrift institutions and perhaps for banks, too.

The more fundamental reason for moving toward deregulation gradually is that the ultimate results of structural change in financial markets are only dimly perceived when the structural change begins. The history of the postwar period indicates, I believe, that the side effects of innovational change can easily escape us, and often do. The task we face is to use public policy to guide the innovational process in financial markets in ways that contribute to a healthier, more efficient, and more equitable financial system. I look forward to working with you in that endeavor.

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