For Release on Delivery
Expected at 9:30 A.M., E.D.T.

Statement by

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before the

Subcommittee on Monopolies and Commercial Law

Committee on the Judiciary

United States House of Representatives

July 8, 1981

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I am pleased to be here today, on behalf of the Federal Reserve Board, to discuss issues of concern to this Committee regarding recent mergers within the financial services industry. News reports of recent and proposed affiliations suggest a rapid pace of change in the structure of this industry. You are not alone in being concerned with these developments. Commercial banks and thrift institutions are uneasy about the increasing incursions into their traditional domain. The Federal Reserve Board is also keenly interested for a number of reasons. We are one of the financial regulatory agencies charged--together with the Comptroller of the Currency and the Federal Deposit Insurance Corporation--with responsibilities for preserving healthy competition in the financial sector and a safe and sound banking system. In addition, we must be alert to developments in financial markets that have a bearing on our responsibilities for the conduct of monetary policy.

Public attention has recently been captured by a few mergers of large firms in the financial services industry, and by announcements of affiliations between brokerage firms and firms providing "bank-like" services. The significance of these developments, however, is perhaps better understood from a longer-term perspective. Let me therefore begin by reviewing some major trends in the financial services industry over the past quarter century.

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During that period, the rate of inflation has gone up sharply, and carried interest rates to ever higher levels in its wake. The premium on maximizing the returns earned on financial assets has therefore been greatly increased. Households and businesses have paid increasing attention to protecting the real value of their assets, and have become increasingly sophisticated in cash management techniques. The rapid pace of technological change in the computer and communications fields contributed to these developments by opening new opportunities for aggressive and competitive entrepreneurs to make innovations in financial services. And as economies of major nations have become increasingly interlocked, pressures of foreign competition have encouraged changes in financial institutions and the structure of financial markets.

Because of the increased sophistication of customers and their heightened sensitivity to interest rate differentials, depository institutions can no longer expect an automatic flow of deposits into zero-interest checking and low-interest passbook saving accounts. Consequently, these institutions have sought to circumvent legislated or regulatory interest rate ceilings by more extensive use of liabilities not subject to ceiling, such as large, negotiable certificates of deposit, or by offering imaginative new services, such as automatic transfer accounts.

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New institutions, such as the money market mutual funds, have also sprung up. Major regulatory changes--such as the authorization of money market certificates (MMCs) in 1978 and the phasing out of deposit-rate ceilings just announced by the Depository Institutions Deregulation Committee--have been made in response to these circumstances. As a result, there has been an enormous expansion in the variety of financial assets available to savers.

As I noted earlier, technological advances are playing an important role in this changing structure of the financial services industry. Without advances in the computer and telecommunication industries, automatic transfer, pay-by-phone and similar services would be prohibitively expensive. Automation of data production and transmission will continue to have a major role in shaping the financial industry. An increasing volume of financial transactions will be cleared electronically through automated clearing houses, or transferred by wire. These technological developments will allow virtually instantaneous flows of funds between financial instruments and institutions at very low costs.

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Pressures to provide more and better financial services have blurred the distinctions between classes of financial institutions and between financial and nonfinancial firms. This develpment is still far from complete. Differences remain between banks and savings and loan associations, although they are narrowing. And the once firm boundaries between depository institutions and other types of financial firms, and between financial and nonfinancial businesses, are also weakening. The recent mergers are, thus, one more illustration of a general trend under way for a number of years.

Viewed from the perspective of securities markets, another important forerunner of recent affiliations between brokerage firms and other financial institutions was the introduction of competitive brokerage rates on securities in 1975. This change reduced the profit margins on traditional lines of brokerage business, and encouraged aggressive firms to diversify their activities. Some firms could not survive and a substantial number of mergers have occurred in the brokerage industry. This has not, however, led to a diminution of alternatives available to consumers. In fact, just the opposite has occurred. A wide array of different types of retail brokerage firms has come into existence. Some firms provide a complete line of products, including investment research and

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advice. Others provide securities transaction services at sizable discounts, and very little else. The result has been an increase in the options available to the investor at lower prices. He can choose between full service or limited services, high or low commissions, massive investment research or none at all.

These developments in the brokerage industry help to explain the shrinking differentiation between brokerage firms and other financial institutions. They also illustrate that change and consolidation may result in increased competition, new services, and lower prices for consumers in the financial services industry.

Let me now turn to your question regarding the possible effects of these trends on banks and thrift institutions, and particularly on the small and medium-sized institutions. How will these institutions fare in a world of increased competition? The record of the past two decades and longer, when competition among financial institutions was steadily increasing, attests to the basic strength of our nation's depository institutions and their capacity to adapt to a changing environment.

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Table 1 shows, for example, that banks supplied 27 percent of the total credit borrowed by the nonfinancial sector in the five years 1976 to 1980. This was lower than the share they provided in the 1960's and the first five years of the 1970's, but it is well above the 20 percent share that prevailed in the 1950's.

The share of total credit supplied by mutual savings banks, savings and loan associations, and credit unions, on the other hand, has not changed markedly during the past 15 years, but is below what it was in the 1950's and early 1960's.

The share of total household savings in the form of deposits and credit market instruments captured by commercial banks has also decreased from the level of the 1960's, as Table 2 indicates. Again, however, it is higher than it was in the 1950's. The thrift industry's share of household savings in these forms, however, declined over the thirty-year period. These data do not, of course, reflect the influence on deposit shares of NOW accounts and share draft accounts. Moreover, the gradual removal of Regulation Q interest rate ceilings may help to reverse this downward trend at thrift institutions.

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Further indication of the ability of commercial banks to compete can be found in the history of their earnings. Rates of return on assets and equity capital for the banking industry are presented in Table 3. For the industry as a whole, profitability has risen over the past thirty years. Evidently, the commercial banking system has coped quite successfully with innovation and change.

For most of the past decade, thrift institutions also held their own (Table 4); their earnings were close to those of earlier periods. Earnings of thrift institutions, however, are very sensitive to changes in rates of interest. During the past year or so, the combined effects of rapid increases in interest rates and the imbalance between the maturity of their assets and their liabilities have sharply reduced earnings in the thrift industry. The thrifts will be subject to earnings problems until they are able to make more new, higher-yielding mortgage loans, and in other ways to diversify their asset portfolios.

The earnings experience of all banks or thrifts, however, need not reflect the problems of smaller institutions. Data for these smaller institutions is more difficult to obtain.

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Table 3, however, shows earnings of small banks over the past decade. Earnings were higher for the small banks in the second half of the decade than in the first, and higher, also, than for large banks. Indeed, even ratios of earnings to capital for small banks exceed those for large banks, despite the fact that ratios of capital to assets of small banks are roughly double those of larger banks.

There is other evidence supporting the view that small banks can survive in the current environment. For 1980, a detailed sample of small banks shows that, in 156 of 265 Standard Metropolitan Statistical Areas, the smallest size category of banks in each area earned a higher average return on assets than the largest size group in each area. Thus, even in these large and highly competitive urban markets, small banks have been competing effectively.

How is it possible for a small bank, with (say) less than $100 million of assets, to hold its own against multi-billion dollar banks? Part of the answer is that there are relatively few economies of large scale operations in commercial banking. That conclusion has emerged from a number of careful empirical studies.

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In addition, small banks offer many of the unique services of the specialty shop. A customer may be able to talk directly to the senior bank officers, rather than to a branch manager who has limited decision making power. Moreover, if a customer requires a specialized bank service that cannot be supplied by the small bank directly, arrangements can often be made to provide it through one of the small bank's correspondents.

I would hazard the guess that there will continue to be a substantial demand for the specialized services that small banks provide. Consider for a moment the evidence from other industries. In the retail trade sector, we have giant chain department stores offering a wide range of products in outlets across the nation. We also have small specialty shops offering one or two product lines. Similarly, retail food outlets differ markedly in their size and degree of specialization. And, although there are high rates of business births and deaths in retailing, there are many examples of competition among long-established stores of differing sizes. Yet another, more striking illustration can be found in the steel industry--where smaller firms, using new technology, are able to compete effectively with industrial giants both here and abroad.

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Let me turn next to the question of how consumers of financial services are affected by recent trends. Thus far, consumers have clearly benefited from the interwoven effects of product innovation and institutional deregulation. More firms are competing in the sale of more financial services than before. Some of them are old-line financial firms; others are new, or predominately nonfinancial, firms offering financial services.

The consumer has increased freedom to pick and choose between institutions, services, and pricing systems. For example, savers are able, more readily, to obtain market rates of return on a larger part of their financial assets. Nationwide expansion of NOW accounts carries this process another step by making it possible for households to receive interest on checking accounts. At the same time, consumers are learning to shop among institutions imposing different minimum balances and service charges. Previously, many of these charges were, in effect, netted against low or zero interest payments on accounts rather than appearing explicitly.

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Similarly, financial services increasingly are being unbundled. Rather than dealing with one institution for all services, the consumer has the option to deal with a variety of service vendors. The services of a checking account may be purchased from a commercial bank while the saver may, if he chooses, place temporarily idle balances in a money market mutual fund and obtain a consumer loan from yet another type of financial institution. One-stop-shopping may still appeal to many consumers, but there are now other attractive alternatives available as well.

Can we be sure that these benefits extend to all classes of customers--including farmers, local communities, minorities and small businesses? Or will their needs for credit and other financial services be neglected? The answer to that question requires weighing benefits and costs. On the benefit side of the ledger, these specific groups of customers can expect to gain, much as consumers in general, from heightened competition, from the ability to obtain market rates of interest on financial assets, and from the unbundling and more explicit pricing of services. In addition, business and household borrowers generally can expect to gain because more and more banks are entering new market areas, by opening loan production offices, Edge Act affiliates, and commercial lending subsidiaries. Also, thrift institutions are beginning to offer types of loans previously available primarily only at commercial banks.

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Recent changes in financial practices have also altered significantly the way in which a limited supply of credit is allocated among potential borrowers. Interest rates have increasingly replaced non-price limitations as a means of rationing the available amount of credit. Before the authorization of money market certificates and the subsequent additional modifications in deposit interest rate ceilings, individuals would divert funds from depository institutions to market securities in periods of sharply rising interest rates. This shift in savings flows would result in a sharply reduced <u>availability</u> of loans--for mortgage and construction financing, and for farmers, small businesses, and others. Recent regulatory changes and financial innovations have substantially reduced the extent to which monetary restraint results in sharp reductions in the availability of credit to particular borrowers. But it has done so at the expense of much higher interest rates to these borrowers.

This point can be illustrated as it relates to credit costs and availability to local communities and the agricultural sector. Before the 6-month MMCs were introduced in the middle of 1978, small rural banks found that they often lost deposits to the pull of higher interest rates in the central money markets,

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and they sometimes had great difficulty in meeting the loan demands of their regular customers. The MMC has enabled agricultural banks to remain more competitive in the market for savings--and they have played a particularly important role in enabling rural banks to compete against money market mutual funds which may tend to divert funds to urban areas. By March of this year--slightly less than three years after the MMC was introduced--it accounted for 27 percent of the total resources of agricultural banks.

The shift into MMCs from passbook savings and other low-rate instruments, however, has resulted in a marked increase in the average cost of funds at these banks, and it has made their costs much more responsive to swings in money market rates. Consequently, farm loan rates have risen sharply, and now tend to fluctuate in response to changes in the overall level of interest rates.

Thus, when financial markets provide savers with more opportunities to earn market interest rates, credit flows more freely to borrowers. Financial markets operate more efficiently in channeling funds to the highest bidder. But, when inflation pushes interest rates to extremely high levels, this market efficiency imposes severe cost increases on those sectors of the economy most dependent on credit.

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What conclusions for anti-trust policy flow from this assessment of developments in the financial services industry? Let me point out, first, that we see hundreds of mergers and acquisitions in banking each year. Fortunately, however, hundreds of new banks are also established, and the number of banking organizations has changed very little in the past decade. Actually, the proportion of total bank deposits held by the largest banks has declined slightly over the years.

Will these highly publicized recent mergers between nonbank financial firms squeeze out competitors? To do so, they must, first, produce successful operational entitites. It is still too early to tell whether this will happen. Many mergers do not produce the expected cost reductions or profit growth. The results are sometimes disappointing, even when the merging firms produce the same or closely related products. In other cases, it is years before the benefits of the merger are realized.

For example, in the 1960's, there was great concern about industrial conglomerates, but many of those conglomerate firms never achieved the expected profit results and, in some cases, the acquired firms were later divested.

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The success of recent financial conglomerates has yet to be proven. Can a salesperson in a brokerage office be as knowledgeable about money market funds, life insurance and real estate as he is about stocks and bonds? That is not clear. The specialist in each of these areas may have an advantage in information and experience. In addition, the commission system may orient the salesperson towards his major product, rather than other less remunerative lines.

Market factors frequently result in the market share of a combined firm being less than the sum of the market shares of the merging firms. For example, the merger between American Express and Shearson may cause some banks to regard American Express as a major competitor, and reduce their willingness to purchase services supplied to banks by American Express. Moreover, if a particular merger is successful, new entry by competitors will be encouraged into the most profitable service lines.

These considerations suggest that recent trends in the structure of the financial services industry do not raise immediate alarms about the resulting effects on the pricing and

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availability of financial services to the public. The developing pattern of conglomerate mergers bears watching, but it is much too early to suggest a need for policy actions. These developments do raise questions for the Federal Reserve, however, regarding how to preserve equitable competition among different types of financial institutions, while maintaining their safety and soundness and the effective operation of monetary policy. I would like to discuss these issues briefly.

One important question is how to achieve an equitable environment for competition among commercial banks, thrift institutions, and other producers of financial services. The Monetary Control Act of 1980 set in motion some important steps toward this goal. Reserve requirements will be adjusted so as ultimately to impose a uniform requirement on all regulated institutions. The Act also required the Federal Reserve to charge explicit prices that cover costs for the financial services it provides, and to permit private firms to compete with it in providing check clearing and other services. The schedule for phasing out interest rate ceilings adopted by the Depository Institutions Deregulation Committee at its June 25th meeting provides a program for adjusting interest rates to market levels. Now, institutions can plan their full transition to the new deregulated environment.

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Banks and thrift institutions, nevertheless, remain more closely regulated than other financial institutions with which they now compete. Questions arise, therefore, concerning the constraints on geographic expansion by depository institutions. When money funds and nonbank providers of financial services can operate nationwide, is it equitable to restrain banks to states or smaller areas?

Limitations on the security underwriting activities of commercial banks and other similar limitations imposed by the Glass-Steagall Act may also need to be reexamined. A proper balance between the safety and soundness of financial institutions, on the one hand, and the advantages of unfettered competition, on the other, may entail a different range of commercial bank activities today than it appeared to permit when the Glass-Steagall Act was passed in the 1930's. Similarly, the question of the appropriate mix of activities now applies to the broader class of institutions that provides bank-like services.

Finally, recent developments also have implications for monetary policy. As Chairman Volcker testified on June 25th, measurement and control of the monetary aggregates is complicated by the existence of money market mutual funds. The Board

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believes that legislation would be desirable authorizing the Federal Reserve to impose reserve requirements on those money market fund shares that serve as the functional equivalent of transaction balances, and to enforce a cleaner distinction between transaction balances and other liquid savings. In addition, we believe, the Federal Reserve should have the authority to define transactions accounts for purposes of reserve requirements so as to include the many new types of plans with transactions capability that may develop.

In concluding, I would like to emphasize that the Board of Governors believes that recent developments in the financial service industry have, on balance, enhanced competition despite the other complicated regulatory questions they raise. These innovations are a sign of a healthy, dynamic and innovative financial sector. To be sure, we need to monitor developments carefully to ensure that changes such as the recent conglomerate mergers do not result in the development of monopolies or monopoly power at some time in the future. But the principal questions these developments now raise relate less to the maintenance of competitive markets for financial services than to the need to provide for a more level playing field for depository institutions and their competitors, to maintain appropriate standards of prudence and safety, and to ensure that the monetary controls of the Federal Reserve are not undermined.

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Table 1
Bank and Thrift Credit Supplied to Nonfinancial Sectors
as a Percentage of Total Borrowing by Nonfinancial Sectors
(5-year averages[1])

	Commercial Banks	MSBs & S&Ls	Credit Unions
1951-55	20.0%	18.8%	0.9%
1956-60	20.8%	22.1%	1.4%
1961-65	31.4%	23.3%	1.2%
1966-70	31.2%	13.1%	1.4%
1971-75	29.5%	18.5%	1.6%
1976-80	26.9%	15.6%	1.6%

1. All data based on annual flows, excluding equities.

Source: Flow of Funds Data, Federal Reserve Board.

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Table 2
Bank and Thrift Acquisition of Deposits
From the Household Sector as a Percentage
of Total Household Acquisitions of Deposits
and Credit Market Instruments
(5-year averages[1])

	Commercial Banks[2]	MSBs & S&Ls	Credit Unions
1951-55	32.4%	39.5%	2.4%
1956-60	25.5%	38.6%	2.6%
1961-65	43.3%	38.5%	2.6%
1966-70	43.3%	22.8%	2.6%
1971-75	39.1%	34.3%	3.4%
1976-80	34.2%	29.6%	3.3%

1. All data based on annual flows.
2. Includes demand, savings and time deposits.

Source: Flow of Funds Data, Federal Reserve Board.

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Table 3
Five-Year Averages of Commercial Bank
Profit Data

Years	Ratio of Net Income to Total Assets		Ratio of Net Income to Total Equity Capital	
	All Banks	Small Banks	All Banks	Small Banks
1951-55	0.58		8.03	
1956-60	0.68		8.50	
1961-65	0.72		8.80	
1966-70	0.78		10.80	
1971-75	0.83	0.95	12.36	12.52
1976-80	0.78	1.06	12.56	13.16

1. Small bank series includes all FDIC insured banks with assets less than $100 million and excludes new banks in the year of their formation. Data series is not available prior to 1970.

Source: Federal Reserve Board.

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Table 4
Net Income to Average Assets
for Thrift Institutions
(5-year averages)

	S&Ls[1]	MSBs
1961-1965	0.80	0.45
1966-1970	0.56	0.30
1971-1975	0.65	0.47
1976-1980	0.61	0.40
1979	0.67	0.47
1980	0.14	-0.10

1. Data is for FSLIC-insured S&Ls prior to 1976. All S&Ls included for 1976 and subsequent years.

Sources: National Association of Mutual Savings Banks and Federal Home Loan Bank Board.

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