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WHAT LIES AHEAD IN BANKING?

Remarks of

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I am pleased at the opportunity to join with you at this pre-graduation dinner. The proper subject for the graduation season is the future, and therefore I should like to discuss with you the future that concerns me most, namely, the longer-term outlook for the banking industry. This will, I hope, prove a topic of some interest not only to those of you directly interested in the future of banking and finance, but also to those who will be shaping the future of business generally. For the well-being of business is significantly dependent on the future health of the financial system, and the commercial banking industry is a central element of that system.

I should emphasize that in these comments I speak only for myself and not for my colleagues on the Board. These represent my personal views of the factors that appear to be impelling the rapid evolution of the banking system.[1/]

1/ For assistance in the preparation of this paper, I am indebted to Mr. Paul Metzger, who is Assistant to the Managing Director for Operations and Supervision and the chief long-range planner on the Board's staff. The views herein expressed, however, are my personal responsibility.

The changes that have taken place in banking over the past decade, as well as those changes that will occur over the next decade or so, have, in my view, been expressions of certain underlying causal forces. In order to give you as balanced a sense as I can of where banking may be headed, I shall touch not only on the impact of these forces, but also on certain vulnerabilities and constraints to which they may be subject.

The Board's Longer-Range Concerns

While these views are very much my own, they have been shaped in part by the on-going discussions about the future of finance and banking that have, for some time now, been taking place within the Federal Reserve Board. We have been attempting at the Board to take a longer view of possible developments in the financial system, and particularly in the banking industry, in order to be better able to assess the possible impacts of these developments on our areas of responsibility and determine what we should do about them.

Let me give you two recent examples of how such concerns have been reflected in positive initiatives undertaken by the Board. One such concern has to do with the need to insure an adequate future base for monetary policy. It is in this light that the Board's proposed legislation broadening the scope of reserve requirements can best be understood. In a second area, the Board has sought to insure the continued smooth functioning of the payments mechanism over the longer term through the establishment of Regional Check Processing Centers designed to speed up the flow of checks. An additional outgrowth of this same concern for the efficiency of the payments mechanism has been the Board's proposal regarding the steps that might be taken to move us towards a national electronic funds transfer system.

Having said something now of the Board's efforts to assess longer-term trends and to act to meet the possible future impacts of those trends, let me turn to an examination of what seem to me to be the basic forces now at work in banking, and how they may shape its future over the next decade or so.

The Banking "Revolution"

It has frequently been said that over the last ten to fifteen years a virtual "revolution" has been underway in the very nature of banking, as compared with Depression-era banking. I would agree with those observers who have noted that banking is taking on a strikingly new pattern, a pattern that is a key part of the evolution that the entire financial system is undergoing.

To appreciate this rather dramatic change more fully, we need only think about a few of the more salient developments that have been taking place. These would include: widespread bank utilization of certificates of deposit and other money market instruments in order to raise funds; the growing reliance of banks on services for a fee to offset increasing customer economization on demand deposit balances; the heavy dependency on computer technology both within and between financial institutions; the growth and diversification of bank holding companies both in the United States and abroad; the development of the Eurodollar market; and the increasing integration and interdependence of economic and financial systems throughout the world, particularly among the highly industrialized nations.

These very significant changes have required most leading banks to develop a different style of management--more sophisticated, frequently internationally oriented, even enterpreneurial. It should be noted that all of these developments are by no means fully integrated as yet into banking or the broader financial system, but rather are gradually becoming assimilated, and so the full impact of these changes has perhaps still to be felt.

Forces Shaping Banking

It seems to me that the basic causal factors reshaping the banking industry have been, and will for the foreseeable future continue to be, customer demand and bank management response thereto. The nature of this demand has become evident in several ways. Banks have to face increasingly affluent and increasingly sophisticated individual and corporate customers who are insisting on a return on their money, and therefore tending to draw down demand deposits to minimal working capital needs. These same customers are requiring more elaborate and complete financial services, placing pressure on banks as their financial suppliers to provide more integrated and convenient services for a still wider range of customers. Customers' concepts of money management have thus become much more sophisticated, and a new generation of bank management --trained in business schools--is moving rapidly in this direction. These demands from customers for an attractive return on their funds and for the ready availability of a broad spectrum of sophisticated financial services, will, in my view, act to maintain the momentum of the current trends in banking, barring the intervention of certain vulnerabilities and constraints I will touch on shortly.

The attitudes toward bank stocks on the part of shareholders and bankers are also undergoing significant change. Stock market investors are taking a keen interest in performance-oriented banks. As a consequence, bank and bank holding company managements, particularly those of larger institutions, have become much more conscious of bank earnings, level of performance and extent of leverage to support the marketability of their new stock issues and thus the availability of equity capital for expansion and diversification.

It is important to note that this increased pressure on managements to insure the adequate performance of their banks and bank holding companies is also producing a new management style that is spreading rapidly through the larger units of the banking system. It is a style that contrasts with a prior tradition of management. It is, on the one hand, more driving, innovative, international-minded and sophisticated. But, it is a style that, on the other hand, sometimes can be a bit incautious in its striving for profitable market performance.

Another major causal factor behind the changes banking has been undergoing has been the force of inter-industry competition. Banks have been under growing competitive pressure not only from other banking institutions, but from thrift institutions, insurance companies, diversified financial corporations of various kinds and from nonfinancial firms that extend consumer credit. Thus, a significant factor behind the movement of banks and bank holding companies into bank-related financial areas has been the impelling force of the intrusion of non-banking firms into traditional banking areas. Those firms that now face new competition from banks should recognize that this is in part due to a reaction by the banking industry to the new competition it has had to face. This heightened competition both in traditional banking areas and in bank-related businesses can, if suitably disciplined, serve to promote the public interest.

In the international area, banks and bank holding companies have expanded their operations significantly, in large measure in response to the need to serve better the U.S. firms that have greatly enlarged their own overseas activities. In the future, as more foreign corporations open U.S.-based operations, American banks will no doubt have further reason for diversified foreign activities, since they will want to serve directly the overseas parent firms of the U.S. subsidiaries which may become their clients here. Some major American banks and bank holding companies have already earned, and more will earn, a substantial portion of their profits from dealings with foreign customers both in the United States and abroad. In so doing, they need to be able to compete with foreign banks in the United States and overseas on an equitable basis.

Viewed from a wider perspective, the overseas expansion of the larger U.S. banks and bank holding companies can be seen as part of the broader movement towards an increasing level of world economic and financial integration to which I alluded earlier. Similarly, these same firms' domestic expansion, diversification and changes in management style can be viewed as part of the broader pattern of change that is transforming major corporations generally. The level of responsiveness by U.S. banks to the forces altering so many of their corporate clients may, to a large extent, determine the capacity of these banks to serve these clients adequately and thereby retain their business.

The factors I have sketched out here that seem to me to underlie the on-going transformation of the banking industry are probably not transitory in nature. They should, I believe, continue to exert pressures on banking to change along the lines I have attempted to delineate. Of course, as events evolve, it may be helpful to remember that some of these forces will produce what can best be characterized as "passing fads" in bank management practices. Other bank responses, however, will prove to be lasting alterations of the industry. Distinguishing between these two types of changes may often prove a difficult task for both bankers and bank regulators.

Consequences and Vulnerabilities

Certain consequences flow from the scenario of causal pressures I have described. Banks with the wherewithal will probably continue to press to expand the number and nature of the financially-related services they can provide. They may also seek broader geograpic scope for their expanded services with some chance of success particularly through their near-bank corporate affiliates. There should also continue to be heavy emphasis on the performance of services for a fee in order both to offset the economization of demand deposit balances to which I referred before, and to insure enhanced profitability.

We can anticipate that additional efforts may be made to create instruments attractive to investors and rewarding to banks. As a consequence, variable-interest-rate instruments may be expected to proliferate, and the use of "equity kickers" may also grow.

Yet another consequence that may follow is the gradual emergence of an electronic payments system. Such a means of transferring funds will offer many new opportunities for banks to develop innovative methods of meeting their customers' demands for more convenient and comprehensive services. But just as the banking industry will seek to utilize an electronic funds transfer system as a source of greater profitability, so too will other institutions which may also be afforded access to such a system. Thus, an electronic payments mechanism will no doubt become a source not only of heightened profits for those institutions which utilize it successfully, but also of heightened competition among them across a broad spectrum of both new and old services.

In short, most banks (except those which, for reasons of size and market scope, are relatively insulated from the pressures I have examined) will have to be innovative and responsive to their customers' needs in order to perform adequately their basic function--gathering funds from saver-investors and disbursing them in an inventive manner and at a reasonable profit to the borrowers who seek them.

These developments in banking will, however, most likely be subject to certain constraints imposed by regulatory authorities (which I will detail in a moment) and also perhaps by the impact of certain other factors in the financial environment that I would like to outline briefly now. The banking industry has, I believe, three fairly prominent points of vulnerability where damage might be inflicted should adverse factors materialize.

The first of these points of vulnerability is governmental. My experience over the years in Washington suggests that banks are not nearly so potent in this city as their competitors sometimes imagine. For one thing, their legislated powers are subject to continuing pressure from a number of powerful competing groups.

For another, bank or bank holding company failures--or even an upsurge of very high interest rates--could have the potential for triggering constrictive Congressional reactions.

A second major point of vulnerability could be created by the managements of banks and bank holding companies themselves. Excessive efforts by a management to promote earnings performance could result in a possibly dangerous over-extension of the institution. Moreover, the management of a bank holding company might devote too much attention to its nonbanking subsidiaries' performance, to the neglect of its bank and with possibly damaging consequences for that institution.

The final substantial point of vulnerability is related to the possibility of turmoil in the international monetary system. Some large banks are particularly vulnerable to such a circumstance in terms of the relative volume of their assets and earnings derived from foreign operations. Because of the sheer size of these institutions, if for no other reason, any difficulties resulting from such a state of turmoil might have a significant adverse impact on the banking industry and, indeed, on the financial system as a whole.

These, then, are three areas of potential vulnerability I see that might cause trouble. If these points of vulnerability are not adequately protected, they could serve to stem the trends that are reshaping the banking industry. But there are also, it should be remembered, unique protective constraints imposed on banking by the agencies that regulate it. If we as regulators are able to perform our tasks properly, we can--in some if not all of these areas--act so as to reduce the likelihood that these points of vulnerability will result in injury to our nation's banking system.

Constraints on the Banking System

There are two special constraints placed on banking that require it to function within strictures not imposed on less regulated businesses. The first of these constraints is created by the need to insure the safety and soundness of the nation's banking system.

To my mind one of the critical issues in this area today is whether or not the risks undertaken by a holding company parent and its nonbank subsidiaries may eventually have to be borne by the firm's banking subsidiaries. In either case, some common understanding of where risks may ultimately fall should exist in the minds of investors, regulators, creditors and the general public. The recent banking emergencies involving the U.S. National and Beverly Hills National Banks are perhaps illustrative of the types of misunderstandings that can arise when it is not agreed who shall be the final bearer of any losses. Such common understanding does not exist today, and it seems particularly important that this question be clarified with reasonable promptness.

A second important facet of the safety and soundness constraint is the need perceived by the Congress and by the relevant regulatory agencies to confine bank holding companies to activities closely related to the banking business. I do not believe that we can, or should, anticipate that this line of demarcation will be permitted to disappear within the foreseeable future.

A third issue under the safety and soundness heading is that of capital adequacy for banks (and bank holding companies). The limits that are placed by the regulatory agencies on capital leveraging by banks are necessitated by the special requirements for capital adequacy under which banks must operate in order adequately to safeguard the public interest. As regulators we must recognize that our task is to insure that the capital of banking institutions will be adequate to meet eventualities that may materialize. To require too little capital in banks would create a hazard for the entire financial system; to require too much capital would reduce their efficiency and possibly damage their ability to compete. Thus, regulators, like careful poultry farmers, have to insure that the proverbial "goose that lays the golden egg" has sufficient provender to nurture it, but not so much that it chokes.

As you may know, this issue of what constitutes adequate capital for any given bank is a controversial question. The answer to that question involves many judgments, on which reasonable men can differ. The Board has been engaged for some time now in careful reevaluation of this complex issue, in view of the changed banking environment. We hope, in the not too distant future, to be able to cast some further light upon this subject.

The second of the constraints to which I have referred is imposed by the needs of monetary policy. The commercial banking industry performs the very difficult but necessary role of the transmitter of monetary policy. As such, it is directly subject to the periodic tightening of money through the operations of the Federal Open Market Committee, the various controls placed on the discount window's functioning, and the impact of reserve requirements on banks that are members of the Federal Reserve System.

I think banking must come to accept that it will continue to find itself subjected to the periodic pressures imposed by the need for monetary restraint. On the other hand, it is clearly inequitable for only some commercial banks, and not others, to bear the burden of the apparatus of monetary policy. The Board has therefore requested Congress to place more uniform reserve requirements on all institutions accepting demand deposits. These proposals we believe would broaden the base of monetary policy and promote greater competitive equality within the banking industry and, to some extent, between banking and thrift institutions.

Conclusion

I hope that my remarks here this evening, delineating my particular personal view of what may lie ahead in banking over the next decade or so, have proven helpful to you. The forces shaping the evolving banking system are, I believe, long-term ones that will prevail, unless stemmed by the vulnerabilities of banking or excessively hampered by the constraints under which banks must operate. The transformation that the banking system has undergone thus far, and should continue to experience, should not be a cause for alarm, but for gratification over its potential contributions to national economic welfare--and for renewed efforts on the part of banks' competitors.

We must remember that the forces that are altering the nature of banking are, in greater or lesser degree, also impacting on the entire financial system. To move through this period of significant and wideranging change smoothly, innovatively, profitably, and with consideration of the larger public interest we all serve, is the great challenge confronting those of us with an abiding interest in banking and finance.