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Remarks of J. L. Robertson
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The Changing World of Banking

I am glad to be speaking in Columbus because there is something about the name that inspires one to want to strike out in new directions and try to foresee what may lie ahead on the uncharted sea of the future. The people of Columbus are fortunate to live in a city that evokes this kind of reaction. They are also lucky to live in a place that has a ready-made fame.

I had no such luck. I was born and reared in Broken Bow, Nebraska. Just think of the difference! Not only was Broken Bow unknown to the outside world, but the very name conveys a sense of bad luck, if not outright failure. But do not waste your sympathy, for Broken Bow has come into its own. At long last it has broken into the movies, in a film called "The Broken Bow Story" produced by the American Petroleum Institute.

It is the story of how a small Nebraska community has tried to solve the problems brought about by changing times. Broken Bow has entered the arena to compete for tourist dollars with Paris, Rome, New York, Las Vegas.

My hat is off to my home-towners for showing so much of the spirit of Columbus. And it occurs to me that we bankers and central bankers might well emulate them in seeking to devise new ways of meeting our changing problems - and believe me, we have them! We will always have them because we live in an economy that is eternally in the midst of a "perpetual gale of change".

Financial markets and institutions have generally played a leading part in the changes that have characterized American business, but during the last seventy-five years commercial banks have more often followed than led. Thirty years ago, for example, many bankers believed term loans - if not sin themselves - led to sin, and considered consumer lending to be far beyond the pale. For too many years commercial banking accorded undue allegiance to outdated rules of thumb. But recently, and at an accelerating rate, the walls of tradition have been collapsing as the pressures of competitive forces in all financial markets have swept the gale through bank offices.

Over the years, most banks passively accepted the deposits of the public and allocated them to borrowers. In the postwar years, however, something happened. Business firms discovered the high cost of holding extra dollars in nonearning form and they aggressively began to place their temporarily surplus funds in the money market. Similarly, small savers began not only to learn of mutual funds and other securities, but also became conscious of the yields and safety available at the savings and loan association, the savings bank, and the credit union.

Commercial banks, to be sure, were subject to legal limits on the amount of interest they could pay on their deposits - zero on demand deposits, of course, and limited yields on time and savings deposits. But many banks were not taking full advantage of existing latitude for their competitive endeavors. In mid-1960, for example, a large portion of our commercial banks, not aware yet of the changes at work, or perhaps convinced that it would not increase their fund sources, were not paying the maximum rate on any form of time or saving deposit. They were not aggressively seeking such funds. Many of them were content to speak of unfair competition and to seek demand deposits merely by emphasizing the importance of the services they performed for their customers. While other financial institutions waxed and grew fat, commercial banks found their own growth was small, indeed.

In exercising its central banking powers to achieve high levels of economic growth and employment, along with stable prices, the Federal Reserve must keep its eye on total flows of funds, and all sectors of the economy. Within that context, it cannot make the banking system grow any faster than the public's demand for bank services. The real determinant, therefore, of the size of individual banks and the banking system - in relation to the size of other types of financial institutions - is the amount of dollars of deposits they can capture.

Financial flows are like a network of pipes connecting a tank of water to many taps. The size of the total flow is influenced by many things, but in general the pressure in the tank is such that if more goes through one pipe,

less goes through another. If you have ever been taking a hot shower when your wife turned on the dishwasher, you will know what I mean. Now the main pipe used to be going to banks, but other financial institutions, and other financial assets that the public could hold, tapped the tank, and the flows through these new pipes cut down the flow to bank deposits. In order to achieve desirable economic growth and stability, we at the Federal Reserve are concerned, as I said, about the total flow - trying to make sure that the whole system of pipes does not either run dry or burst with too much pressure. Our job is not to direct which pipes are used. However, if commercial banks themselves can expand their pipes, as many have demonstrated can be done, they will get a larger portion of the flow. In short, your growth depends more on you than on us.

As the last decade progressed, many people became aware of this. Individual bank managements began to try to do something about it. "If you can't lick them and you can't join them, then copy them and go them one better." Banks began to do just that. The result has been an almost revolutionary evolution in banking during the 1960's, the major cause of which has been competition. The characteristics of the evolution are seen most clearly on the liability side of the balance sheet.

Banks grew tired of seeing funds that had traditionally been theirs go elsewhere - to other kinds of financial institutions or into financial assets other than deposits - and they decided to fight back. Not only did they aggressively begin to merchandise savings accounts, but also they decided that corporations could be persuaded to buy negotiable time certificates of deposits. Paying interest to corporate customers was painful, but banks had to fight back. And the fight has been successful. In five years, negotiable CD's rose from a few hundred million dollars to \$13 billion and became the second largest money market instrument in existence - led only by Treasury bills. Corporations, state and local governments, and institutions found that the CD was a good substitute for bills and other money market instruments, and the banks found themselves with more funds to lend and invest.

Bank regulatory authorities helped banks go after interest-bearing deposits more aggressively by raising the ceiling rates four times since 1957. Many banks have taken advantage of these new limits. Banker cries of unfair competition have diminished, and recently we have heard some grumblings from other financial institutions that sound suspiciously like the bank complaints of a few years ago.

Time and savings deposits were not the only instruments pushed by the banks. Relaxation by regulatory agencies and the new aggressive spirit also led to some long-term capital borrowing. Since 1960 around \$650 million of subordinated debentures have been issued. The old emergency security, with a smell of distress, became in the 1960's - in the view of some people - one of the signs of the aggressive bank. Another tradition crumbled.

In the summer of last year still another instrument to acquire funds came into use: the unsecured short-term note. The terms of this piece of paper are hard to distinguish from those of a CD, but since it is not called a deposit it is not (for the present, at least) subject to reserve requirements, insurance assessments, or interest ceilings. Although less than \$200 million of these obligations have been issued thus far, this gimmick (that is what it really is) could become much more important in the future (unless, of course, the Federal Reserve should decide, under its existing powers, that these obligations should be called by their true name, "deposits", and regulated as such).

In addition to competition of bank deposits with both obligations of other kinds of financial institutions and a whole spectrum of other financial assets, another force at work on bank liabilities has been the desire of banks to manage their fund flows more efficiently. Since the Treasury-Federal Reserve "accord", and the return to a contracyclical monetary policy, we have seen a rapid growth of the Federal funds market. This has allowed banks to manage their legal reserves more closely and market forces to better allocate surplus reserves. Not only does trading in these balances at the Federal Reserve give banks both additional liquidity and income, but it also gives us a very

sensitive measure of the degree of tightness or ease in the money market.

This market is still, in the main, a reserve adjustment and liquidity market, but even here the gale is blowing. Just in the last few months we have seen a few major banks begin to pay in excess of the discount rate for Federal funds, in an explicit effort to promote the idea that Federal funds transactions need not be limited to the objective of reserve adjustment. If assets are available that yield more, it is argued, why not borrow Federal funds and buy them; the day the cost of Federal funds exceeds that yield, stop borrowing and sell the assets. This development is not inconsistent with basic market principles, and may serve to allocate funds nation-wide in a more efficient manner. Unintentionally, it may even increase, in a small way, the effectiveness of changes in monetary policy - for instance, if and when we switch to a policy of so-called tight money - by linking more financial assets still more closely to Federal Reserve actions.

However, you may be surprised to learn that I know of a case in which Federal funds borrowing represents a major - if not the major - source of a bank's funds to finance a long-term and not-too-liquid portfolio. This represents a misuse of short-term borrowing; a misuse in which both the borrower and the lenders could get hurt.

Paralleling the more active use of the Federal funds market, there has been a similar growth in another source of funds. Dealers in United States government securities have for years borrowed money via repurchase agreements with corporations, banks, and the Federal Reserve. Now banks are entering this market on the same side as the dealers and engaging in repurchase agreements with corporations - borrowing on their securities rather than selling them. Assuming, as I am willing to do for the moment, that this is not a device to pay interest on demand deposits, it represents just another example of the techniques now used by banks to gain needed funds.

All of what I have said so far can be summarized in one word: change - which, parenthetically, is not necessarily

the same thing as progress. Banks are no longer passively accepting deposits or leaning on service alone to bring in funds. They are out competing for them. They are innovating, introducing new instruments, pushing old ones, changing the purposes of some, and generally paying the market price. They are using that ancient, and too often forgotten competitive shillelagh - price. In the process, they are bigger because they are capturing a larger portion of the flow of funds. It is not only because of the expansive policy stance of the Federal Reserve that 1964 saw the largest dollar increase in bank credit in a decade. It is not just changes in Regulation Q that have caused time deposits to double since 1958. Rather, it is these factors and the growing competitiveness of banks - their active searching for deposits - that has resulted in a bigger banking system. To use my earlier metaphor, the banks have succeeded in expanding their pipes; perhaps it would be more correct to say they have tapped the tank with new pipes.

All of this suggests there has been a new awakening of banking, a new aggressiveness that has changed the nature of the banking business, a change which is exemplified by the fact that in the fall of 1964, for the first time in American banking history, time and demand deposits held by the public were of the same size. Textbooks are going to have to be rewritten, and the banking fraternity, the regulatory authorities, and the policy-makers are going to have to feed all these new factors into their brains and their computers in order to steer a proper course.

Some of the consequences of this change can be seen, and others can be guessed at. For one thing, sophisticated management skills are clearly of increasing importance in this new banking market. Tapping the new sources of funds is not child's play. To the extent that these funds represent borrowing from the market what used to be borrowed from correspondents and the Federal Reserve, the borrower may find the market, in times of need, to be much colder and far less understanding. While banks can now gain funds from a greater variety of sources (and incidentally be emancipated from sole dependence on local area sources),

by and large these new funds are much "hotter" - more volatile - than the old deposit flows. In this field the personal customer relationship is not as important today as the quoted rate - as both the customer and the bank become aware of alternatives.

Banks have always been borrowers - that is how they get their resources - but the latest developments are something new. They are new because more banks are now aggressively seeking short-term, price-sensitive money. This increasing emphasis on short-term funds from the market may actually increase the exposure of individual banks to sudden adverse drains - particularly since policy changes by the Federal Reserve that once influenced mainly your portfolios now also powerfully influence the relative cost and stability of your liabilities. As a result, in adversity many banks may be more dependent than ever on correspondent relations and ultimately on the lender of last resort - the Federal Reserve System. The discount window will, of course, always be there to protect communities and to meet the emergency needs of banks. But it would not be wise to count on its being there to save bankers from the consequences of going overboard in borrowing short and lending long. Furthermore, supervisory authorities should not count too heavily on the use of the discount window to paper over their mistakes and deficiencies.

Some bankers profess little concern about these possibilities, arguing that in the event of adverse shifts of deposits they can always garner the needed funds from the market by playing the game - that is, by offering a bit more for deposits. But this can be a hazardous game. At times, because of Regulation Q ceilings, it cannot be played at all with respect to some sources of funds; there is no guarantee that Regulation Q ceilings will escalate in step with market yields. In addition, some banks that experience a hemorrhage of deposits may not be able to replace them merely by raising the price. Yields rise when funds are in relatively short supply, and much more deposit money just may not be around. In 1959 some would-be Federal funds borrowers found themselves in just this situation - they found no lenders.

This problem is magnified now because some of the recent inflows to banks are liquidity balances of corporations. In the event of a contraction in liquidity, these balances may not be available to the banks at rates they can afford to pay - ceilings or no ceilings. These inflows - represented in the main by certificates of deposit - have replaced the stock of liquidity which corporations used to hold in the form of government securities. And here, I think, we can learn a lesson from the past. In previous periods of rapid expansion and tight money these corporate holdings of "governments" have been liquidated pretty fast. If and when corporate holdings of CD's are liquidated for the same reason, banks will have to liquidate some of their assets too. This could add upward pressure on yields and present some real liquidity and perhaps solvency problems to those banks that have not made proper plans for such developments or have relied too heavily on the possibility of replacing this borrowing with new borrowing.

In short, today banks are relying less on traditional asset adjustments for the liquidity needed for both adverse clearings and increased loan demand, and more on deposit inflows and additional borrowing. Given the increasing liquidity risks associated with higher levels of interest-sensitive deposits and the difficulties of increasing borrowings in periods of tight money, this changed reliance could constitute the most dangerous risk resulting from the new trends.

Even if in such periods some bankers are able to get their funds at higher rates, they may find the game not worth the candle; today 180-day CD money costs about the same as the return on a one-year municipal - adjusted for taxes. They may find themselves forced to choose between negative carries - as they pay more for their funds than they can safely earn on them - and selling long-term assets at a loss. Negative carries and capital losses are not very appetizing alternatives.

These problems are, of course, complicated by the fact that the evolution in liabilities has induced a similar evolution in portfolio management. With the cost of bank funds now more obvious, as well as higher, there has been increasing pressure on banks to reach out for more



earnings. In doing so, they have acquired longer-term loans and securities. They have sought tax exemptions. They have looked for the capital gain. The larger ones have engaged in lending abroad on an unprecedented scale, and nearly all have attempted to employ more of every dollar borrowed. Not only are loan/deposit ratios at postwar highs, they are growing most rapidly at the smaller banks. More banks are entering the Federal funds market as lenders, as well as borrowers, with a consequent reduction in excess reserves and correspondent balances.

Incidentally, it is just possible that one of the reasons for the large expansion in banks' holdings of mortgage loans and tax exemptions is tradition: a tradition that argues that time and savings deposits, being more stable, may more safely be invested in longer-term assets. It could be, of course, that time deposits are less stable today than many think. The level of a bank's demand deposits may even be more stable now than the level of its interest-sensitive time deposits.

Every bank must test the volatility of its deposits and not blindly follow outdated rules of thumb. Maturities and other characteristics of bank portfolios must be related to the character of a bank's liabilities.

My purpose today is not to alert bankers, only, to the almost revolutionary character of recent changes in the banking business, but bank regulatory authorities, as well. They, too, will be challenged by this new wave of competitive bidding for funds and its consequences.

Those of us on the policy and supervisory side have to beware of the twin temptations of bureaucracy - the temptation to resist change because the status quo seems safer and more comfortable, or, at the other extreme, the temptation to let down the bars indiscriminately in order to calm the complaints or court the plaudits of the "client" industry.

We need to develop new supervisory guidelines on many issues if the public interest is to be effectively served. For example, what are reasonable uses today for highly volatile and highly interest-sensitive money? What is a reasonable pattern for maturity distribution of earning assets?

How much should banks depend upon money market borrowing to ease liquidity pressures, and how much on asset maturities? To what extent - and how - should banks be cushioned from the consequences of misjudgments in balancing the liquidity of their assets and liabilities?

A problem rarely spoken of for thirty years may return to wrinkle the supervisory brow: To what extent should small banks be protected from the ability of large banks to bid away their deposits with deposit instruments that pay more and are more marketable? How can this be done without depriving bank customers of the benefits of vigorous bank competition? Assuming that the pattern of reserve requirements is switched (as may happen) to a graduated scale based on deposit levels, will it be necessary - in order to avoid the demise of smaller banks - to raise the requirements at the billion dollar end of the scale? or, perhaps, to prescribe a high reserve requirement on deposits represented by negotiable CD's? Or can and should more suitable equalizers be devised?

Clearly, traditional regulatory attitudes are called into question by the change that has occurred. For example, both laws requiring interest rate ceilings on time deposits and those prohibiting interest on demand deposits can become real issues. As the styles and terms of bank liabilities proliferate, old dividing lines lose more and more of their meaning.

What is needed today, in my judgment, is a general recasting of bank regulation - to pay more attention to the functions and effects, both beneficial and detrimental, of bank assets and liabilities, and less attention to traditional forms and procedures, the significance of which has been altered by time and change. How can we bring about such a recasting? Must we stand pat until bitter experience reveals, in hindsight, what was too much, what was near-sighted, and what was ill-conceived? Or should we avoid waiting to be tutored in the school of hard knocks by undertaking reforms based on all the good sense that reasonable men can focus on the problem?

In principle, I daresay, all of us would vote for the latter course. But it is ironic that, just when a well-coordinated, progressive reform of bank regulation is needed, our federal supervisory structure is enmeshed in a tangle of overlapping responsibilities, conflicting philosophies, and procedural cross-purposes that makes prompt and effective action impossible.

If ever events called for a unified federal supervisory structure, this surely is the time. The challenges posed by today's competitive pressures are clear. Bankers, supervisors, policy-makers, and legislators must find the institutional framework and the intestinal fortitude to meet those challenges - and quickly.