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BANKING AT THE CROSSROADS

The Outlook for Change over the Coming Twenty Years

Remarks of

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at

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The Outlook for Change over the Coming Twenty Years

I would like to begin my remarks by complimenting you upon your theme for this Conference--Managing Change. I do so, not as an opening pleasantry, but because, in my view, change, the management of change, and the implications for banking in the present and the coming decade, are among the most pertinent and important subjects to which you could be addressing yourselves at this time.

If this conference results in the identification of a guiding star or two as we move into a period when change itself may be the most predictable factor in our lives, it will have served a vital purpose. I say so because I am convinced that we are in the beginning stages of a time of rapid change that will not wear itself out for many years to come.

The change that we see going on all around us can to a large extent be attributed to technological advances in the electronic gathering, transmitting, storing, retrieving, presenting and analyzing of information. Furthermore, these technological advances, though still in their infancy, are becoming a more and more essential feature of our complex economy.

It is therefore wise of you to have chosen to focus your discussion not merely upon change, but upon the management of change. For if we do not learn how to manage the technology that is becoming available in ever faster succeeding generations, it will manage us. But I am among those who do not fear to welcome new technology, and the change it brings with it, because I am among those who believe that we are capable of foreseeing the implications of such change in sufficient degree to bend it to the purposes of higher quality lives. The management of change is thus, in my view, the indispensable saving grace of the time ahead, and meetings such as this will contribute substantially to learning that management.

While I believe that the technological changes that are taking place in every industry will transform our economic processes in the coming years, I can think of no sector in which the alterations ahead are likely to be greater, deeper-going, and--what is more important--of greater potential benefit to the public, than will be the ease in banking.

As I have already indicated, the lodestone directing this change is the onrushing availability of increasingly useful electronic systems, by which information and transactions traditionally entered on paper--such as checks and other instruments for transferring payments--and carried to their conclusion by the transportation, comparison, counting, balancing and clearing of paper entries, can be done instantaneously and far more economically by wire transfers of computer-held information.

At the structural level, however, there is a further element for extensive change in banking--the recently enacted amendments to the Bank Holding Company Act. These amendments, with certain limited exceptions, bring every bank holding company, whether it has one, or several banks, under the same law. They make possible the association with banking in a bank holding company, of any business closely allied to banking.

When these two factors for change in banking are placed together, I think one conclusion is inescapable:

> In the coming years, among the many changes that will overtake banking, and that banking must adapt to, the single most fundamental change will be in the source of banking's income. Income from banking's traditional source of bread and butter--the lending of funds--will decline proportionately, and be supplanted by revenue generated through services rendered to business and the public.

This is to say that, in banking, the management of change in the coming years will have to direct itself centrally to ways in which a bank can maximize its profits through the growth of services.

Let me spell this out just a little.

Under the new bank holding company legislation, with its expanded opportunities for the association of banking with related businesses, the chief bank executive forming a holding company must decide whether he will continue to regard himself as a commercial banker in the traditional sense, or as something significantly different--a bank holding company executive purveying a wide assortment of services to the public and the businesses he serves.

If the chief executive of the single or lead bank in the bank holding company continues to regard himself as the same commercial banker he has always been, and his business chiefly that of acquiring deposits and lending money, his will be a passive organization.

If, on the other hand, the chief executive of the group regards himself as not merely a lender with some new subordinate interests, but as a leader having new and innovative functions, he will develop his organization quite differently, and with quite different future implications for users of the financial system in our country.

In short, I think that we are upon the threshold of an evolution of the financial sector and that the time has come to reorient our concept of banking. Lending will always, of course, be an important part of banking. But preoccupation with this function will distract the new banking executive from a clear view of the opportunity to become important to the public he serves in many other ways.

I foresee a time when financial advice, bookkeeping, budgeting, and financial management information provided to the customer may be much more important in the customer's eyes than the funds a bank makes available. And, I think these services will be much more profitable.

In pursuit of this banking future, oriented primarily to the customer's needs, it seems to me that we shall all be well served by vigorous and imaginative use of the new legislation to widen banking's scope for financial services through association with financially related businesses. I am not sure, for my part, that we have much choice. The force of the surrounding circumstances tending in this expansionary direction is very great. In the interest of ensuring that these forces result in greater, not less, competition and productivity in the American economy as a whole--and over both the long and the short haul--a rather rapid evolution of our banking system of the type permitted under the 1970 banking legislation may only give legal validation to a choice between an economy losing and an economy gaining in vitality.

In this process, the transformation of our payments system will be both natural and necessary. It will be in step with the de-emphasis of banking's lending function as a source of income. And it will be technically necessary as banking associates with many related activities in the financial field, because these businesses, as is the case with other types of business, will be articulating their processes by electronic handling of this essential data. Banking must possess, and must be adept in using, comparable electronic technology.

If this is a correct view of the future, a future in which banking has an opportunity to move its main profits base to income arising from financial services to businesses and individuals, then electronic automation of banking's business processes will be essential to permit the accumulation, analysis, and retrieval at will of the large masses--and the pinpoints--of data that alone can make viable the furnishing of packages of financial services on a large scale.

This is not a vision without solid foundation in the present. With data processing equipment available, banks are already enlarging the scope of their services. Computers are being used by banks to render one-statement service to clients--showing their whole financial position as known to the bank.

Computers are also currently in use for making up and disbursing payrolls, for servicing trust accounts; for planning travel and purchasing travel tickets; for rendering management advisory services, for control of inventory, for billings for doctors and dentists, for preparing income tax returns on the basis of standardized information inputs, and, to mention just one other service, calculating golf handicaps for the local country club.

I would like to suggest another possibility, which occurred to me on or about April 15. This is that banks could use their data processing equipment to save their customers much time and travail in the preparation of income tax returns by sorting checks according to tax deductible payments made by the client, and presenting the client with a set of deductible totals at the end of the year. I think this could be made a practical and economical fee service, by providing customers of the bank with checks bearing a simple encoding device the client could use when making the check to indicate it is for a deductible item.

In addition to expansion and elaboration of present financial services, banks can, with the help of electronic data processing equipment, add significantly to such services in the years ahead. Financial service packages computerized banks might offer could include such services as financial advice, bookkeeping, budgeting, financial management, complete record keeping for small businesses and payment for them of their sales tax, social security and income tax withholding, real estate management, and record keeping for farms. This is not meant to be more than a suggestion of the many services time and ingenuity will make available to the public.

The most significant financial service banking presently renders to the public is the settlement of payments. This service, presently based primarily on the check method, has served the public well for many years. It has also been profitable for banks that have operated it efficiently and have charged realistic fees for this valuable service.

But we cannot be content with these laurels. On the contrary, there are many indications that we must be on the move to a system of making payments settlements by electronic means.

I say this in knowledge of the fact that you have a full-scale study before you of the question: Will the payments system be good for another decade?, and that, in effect, the answer was, Yes.

But this response must be qualified by the data surrounding it. The study projected a 7 per cent annual increase in the volume of checks written. It was also demonstrated that check handling is labor intensive and resistant to improvement in productivity. That means that as you face the doubling of check volume in the next decade, you cannot expect increases in productivity that will keep unit costs in line.

Further, the underlying data indicated that in order to handle the projected rise in check volume, banks would have to increase the clerical personnel used for this purpose more than the availability of clerical help will increase. This means banking would have to get more than its share of the clerical labor market, and that, in turn, means paying a premium for personnel to handle checks.

This would be accompanied by an increasing management problem in recruiting, training, and maintaining the work force necessary. This, too, would add disproportionately to the cost of accommodating increasing check traffic.

In the event that you are still sanguine about the possibilities of continuing the present "paperful" method of payments settlement, let me touch for a moment on one of the newer developments in banking. It is one that is not generally thought of as part of the payments mechanism problem, but it is in fact a logical extension of the operating programs of the payments mechanism.

I am speaking of the bank credit card. While the use of the credit card accumulates debits rather than causing settlements, the same types of personnel and equipment as are involved in check handling in banks are the logical means of handling this additional financial service.

The total number of transactions currently being created by bank credit cards is not highly impressive. But the trend of bank credit card usage is impressive. We do not have transaction volume statistics, but we do have dollar volume data, which I am taking as a reasonable proxy for transactions volume. Debits created by bank credit card users in the four years from 1967 through 1970, for which we have separate data for bank credit card usage, increased by no less than 352 per cent. There was a drop in 1970 to a rate of increase of 42 per cent--from 101 per cent the year before--but this is still an extremely high rate of increase. Substantial gains can be expected to continue as new uses for bank credit cards are found, new customers begin using the cards, and more banks make this service available.

When you add to projected increases in check volume the prospects for such fast rising transaction volume in debit accumulation caused by bank credit cards, it becomes apparent that it is essential to increase our efforts to move toward electronic handling of transactions in our financial system.

What banks are facing is a <u>cost-feasibility limitation</u>. To put it crudely: you can handle the volume if you don't mind the cost.

But every management that is alive and well wants to go the other way: it wants to reduce unit costs. And we have available, now, electronic technology that can accommodate almost any imaginable increase in the number of transactions requiring settlement, and do so at reduced unit cost.

All of the many studies that have been made in the course of extensive consideration given to this problem have led to the same basic conclusion: there is but one way to reduce significantly the cost of handling payments, and that is to reduce the amount of check handling.

One such study showed that the average check that makes its way through the Federal Reserve's facilities is handled ten times.

The ultimate objective in the reduction of check handling would be, obviously, elimination of the check itself, and substitution of, electronic transfers of money. This should be the goal to which we all aspire.

What would an efficient payment system be like?

First, it must be a system with nearly inexhaustible capacity for expansion to accommodate as many individual, corporate and government users as may wish to partake of its availability. Other attributes should include:

--Lowered unit cost of bank services.

--A system based upon the on-line/real-time electronic transmission of information.

--All transfers between banks would become "good" money transfers, i.e., the transferred amount could be treated as cash, due to simultaneous debits and credits in the system.

--The system would allow for delay in final settlement, at the customer's request and at his expense--i.e., the customer, not society, would pay the cost of float, but, this being done, traditional credit usages could be continued.

--The mechanism could be provided through facilities of the banking system and/or the central bank.

--Universally compatible and acceptable money cards, with secure identification features, would allow either credit or cash to be given to the consumer, upon proper validation, through readily available terminal devices.

--The system would accommodate the continued, although limited, handling of the paper entries of today where this may constitute the most practical payments system.

--There should be means for the extension of at least a basic bookkeeping system to the low-income sector of the public, perhaps through partial subsidy of the cost by government and financial industry cooperative support.

Small steps are being made in this direction, through the introduction of electronic deposit of payroll checks, and by pre-authorized payments by means of paperless entry.

There are many other opportunities ahead for small intermediate steps in the direction of the ultimate objective of a paperless and instantaneous system of settling payments.

However, there is an immediate opportunity to reduce check handling, through maximizing direct exchange of checks. This can and is being approached by expanding existing clearinghouse capabilities and by establishing regional clearance centers.

I view these two types of changes as important steps toward a modern payments system, because they result in significant benefits in terms of bank services to the public, including:

- Earlier collection of and credit for checks;
- Reduction in commercial bank uncollected funds;
- Faster handling of return items and more prompt notification of the return of large unpaid checks;
- Better reserve account management for member banks.

We have completed 15 months of successful operation of a Washington-Baltimore Regional Clearing Facility. In the Ninth and Tenth Districts, immediate payments zones of the Reserve cities have been expanded. We are on the threshhold of launching a further regional clearing center at Miami.

Further, we are cooperating with three projects on paperless entry clearing. The first of these is the program of the Special Committee on Paperless Entry--the SCOPE project in California. In the Twin Cities of the Ninth District, we have assisted in the formation of a counterpart to the California group, while in Seattle the Reserve office is actively participating with yet another committee on paperless entry clearing.

Under the direction of a System Steering Committee on Improving the Payments Mechanism, chaired by Governor Mitchell and including Governor Maisel, myself, three Reserve Bank Presidents and two First Vice Presidents, the Federal Reserve System is actively engaged in a series of studies and steps that we expect to lay the basis for progressive movement to a modern, efficient and low-cost payments system.

First, the Federal Reserve System is adding to the capability of our present communications network up-to-date, high capacity electronic equipment capable of receiving, recording and retransmitting a large volume of information of all kinds, including payments information. This grid is tied to our high-capacity communications switching center at Culpeper, Virginia. It could become a system of trunk lines into which the banking system would feed--and from which banks would receive--information making possible instantaneous funds transfer and settlement. We expect to have our in-System grid at magnetic tape speed within a year to 18 months.

In the area of research, we have two data collection projects afoot. First, we recently announced arrangements with TRW for the construction of a computer traffic simulator of the present payments mechanism. At the completion of six months of work, we hope to have a working model which can be manipulated to test the impact of changes made in the present payment system. And second, the Sixth District Bank at Atlanta is working with personnel from Georgia Tech University to analyze patterns of check flows in the states of Georgia and Florida trying to learn more about the way in which checks are used by individual businesses.

The movements toward changes in the banking system that we have been discussing have aroused apprehensions in some places about institution effect.

I am not among those who fear that reform of the payments system or the widening of bank service functions will lead to harmful loss of traditional identity for any particular segment of the financial community. As change proceeds, some existing boundaries will of course be less sharply delineated. But the test is not whether the traditional segmentation of the financial community is maintained, but is, rather, what financial system formations will best serve the public interest.

As I think many of you know, I regard the small bank as a keystone in our financial system. I want, therefore, to emphasize that I think the small bank will be strengthened by the coming alterations in the scope and the manner in which banking does its business. In the move under the new bank holding company legislation toward a broader offering by banks of financial services to the public, the small bank will be able to market in its own community services offered by larger, correspondent banks packaged by their holding companies. The small bank will, consequently, be able to share in the profits of marketing broadly-based packages of financial services, without itself entering into the building of holding company structures that would be an undue burden on the resources of the small bank. I think most small banks will also share in the benefits of lower cost, modernized payments settlements. But where the check system remains the most practical way of doing business, the new payments mechanism will make provision for its continuance.

I think there will be a general gain for banking in these changes arising from increased public confidence in the ability of the banking system to handle whatever volume of transactions is thrown upon it by the processes of economic growth, and increases in the velocity of money, and public confidence that it can look to its local bank for all necessary financial services.

By prompt and appropriate action to broaden their services to the public, and to take advantage of current technology to speed and lower the cost of payments and other services, banks will be doing much to assure the maintenance of their competitive position in banking.

I am certain that banking will continue its commendable performance of the past in the much changed future, although the winds of competition will blow more hotly than ever, because I am certain that banking will not let change manage it, but will act with speed and ingenuity to manage change in favor of an improved banking system, rendering improved and widened services to the public it serves.

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