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A TIME OF CHANGE FOR AMERICAN BANKING

Remarks of

WILLIAM W. SHERRILL

Member
Board of Governors
Federal Reserve System

at

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I am sure that all of you are familiar with the remarkable works of the famous American philosopher, Leroy Robert Paige, so I want to take one of his well known sayings as my theme today. By way of accounting for one of the longest sustained competitive successes in American history, Mr. Paige -- who may be known best to many of you by his newspaper nickname of Satchel Paige -- has provided this advice for any who would emulate him:

"Don't look over your shoulder -- someone may be gaining on you."

Since Mr. Paige has over the years qualified himself as a full-fledged philosopher -- by never saying anything directly that he can put obliquely -- I take that to be his own way of saying: "Keep moving, and keep a sharp eye out for the competition."

A time of massive change, both operational and structural, lies ahead for banking in the United States -- with concomitant potentials for gaining or losing ground.

There is a handsome prologue to this future. Banking was tested in the past decade by a veritable cascade of financial stresses. Banking can take pride in the fact that in the midst of financial strains that took heavy tolls elsewhere, banks with few exceptions maintained their general soundness. When a crisis threatened last year -- stemming from excessive use by many businesses of short-term commercial credit to avoid the effects of monetary restraint -- the nation's banks, with the support and encouragement of the Federal Reserve, were in position to provide funds that kept a liquidity pinch from becoming a general threat to business financial stability.

Also, over the past decade, banking moved on a large scale to control its costs, and to keep abreast of multiplying demands for payment services, by rapid incorporation into bank operations of newly available mechanical and electronic data processing equipment.

In view of this record, it may be asked, why should banking be cautioned that it must keep moving and keep a sharp eye out for the competition?

In part, the answer is "complacent rests the head that wears the laurels."

But even more important than the temptation to rest easy with its laurels, is the fact that the stresses banking has been through successfully are, in fact, only prologue to what is to come.

It is because the outlook for change in banking over the next decade or two decades is so extensive, so deep-going, and -- the most important consideration -- holds such prospects for improved and lower cost financial services to the public -- that I was glad to have your invitation to come here today to update and continue my public discussion of the extent and probable impact of those changes.

Banking is faced with the problems -- and opportunities -- arising from two converging sets of extensive change. One is rooted in the onrushing availability of increasingly useful electronic data processing and telecommunications systems. The second fount of change in banking is to be found in recent amendments to the Bank Holding Company Act that permit bank holding companies to include any business closely enough allied to banking to be considered an incident to banking.

Implications of the
New Bank Holding
Company Legislation

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

> In the coming years, of 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 bread and butter -- the lending of funds -- will decline proportionately, and be supplanted by revenue generated through financial 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 concern itself centrally in the ways in which a bank can maximize its profits through the growth of fee services.

I realize that this is a prediction of changes of a kind you may not have anticipated, so let me give you the background in my thinking.

Under the new bank holding company legislation, the chief bank executive must make a major decision. He 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 he regards himself as not merely a lender with some new subordinate interests, but as a leader having new and innovative functions, he will develop a new and dynamic kind of organization future with significant implications for users of the financial system in our country.

I foresee a time when financial advice, bookkeeping, budgeting, financial management information and other fee services provided to the customer may be far 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. In the interest of ensuring that these forces result in greater, not less, competition and productivity in the American economy, a rather rapid evolution of our banking is essential.

If I am correct in believing that banking now has an opportunity to move its main profits base to income arising from financial services, then electronic articulation of business processes will be not only desirable but essential. Computer based accumulation, analysis, and retrieval of large masses of data is the only feasible method by which banks can furnish packages of financial services on a large scale.

As you are aware, banks with electronic data processing equipment are already using it to enlarge their financial services to the public. 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 p payrolls; for servicing trust accounts; 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 repeat here a suggestion 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 storing information from checks written for tax deductible items, then providing 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 the appropriate code when writing the check to indicate it is for a deductible purpose.

In the years ahead banks can -- with the help of electronic data processing equipment -- add significantly to such services. 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 could make available to the public.

We at the Federal Reserve Board are moving as expeditiously as possible to implement the new bank holding company legislation with regulations making it operative. Indeed, we are already deciding cases under the new law.

We have published proposed regulations citing ten types of activities that would be presumed to be permissible as being closely related to banking, and the Board is today holding hearings on the last of these proposals. This is a provision that would permit bank holding companies to act as insurance agent or broker.

Like the other members of the Board, I will be giving careful review to the record of this and the other hearings. In the area of insurance, I am reasonably convinced that insuring on an essentially local, small scale basis, such as the method presently used in many unit banking states, has been a public benefit. The only problem, as I see it, lies in finding the means -- which I am sure we can do -- to keep a bank from becoming the treasury unit for a national insurance agency operation.

With the holding of this final hearing, we will shortly be in position to make our proposed regulations final. This will give those wishing to establish or to continue operating bank holding companies "ten most likely to succeed" fields of activities to consider for affiliations. It should be kept in mind, however, that in these as in other fields, the Board must be satisfied, after weighing competitive and other factors -- such as public convenience -- that a proposed affiliation would have net public benefit. We anticipate adding to the original ten fields of permissible activities in the near future.

Implications for the Payments Mechanism

It would be impossible to consider the future of financial services provided by banks without comment on the most significant financial service banking renders to the public at the present time. It is the

settlement of payments -- principally the check system. And here -- in the shift to instantaneous, good-money payments by wire transfer -- many changes in bank operations are in prospect that are as profound as any we shall encounter.

Let me begin my remarks on this subject by commending the Monetary and Payments System planning committee of the ABA for its recent report on the payments mechanism. I am delighted that banking has decided, on its own, that it should move to a full-scale electronics payments system, linked with the Federal Reserve's own developing high capacity grid for electronic settlement of payments.

In the end, it is that payments mechanism which best serves the public interest that must be the payments mechanism put in use.

Let me, then, summarize briefly the need for a change from the "paperful" payments system of the present to the electronic payments system of the future -- for I think that even though the MAPS committee has recommended in favor of such change, there is still much need for explanation and persuasion.

A Cost Feasibility Barrier in Check Handling

The study of the check payments mechanism that the MAPS committee had conducted projects a 7 per cent a year increase in the use of checks. That is to say, a doubling in ten years. It also showed that check handling is not only labor intensive -- despite all progress in mechanizing and automating it -- but that it is resistant to increases in productivity. This means that as the volume of check handling increases, the unit cost cannot be held down by productivity gains. Thus, what banks are facing is a cost feasibility limitation in the volume of checks they can handle. Putting it bluntly, the projected volume can be handled only if you do not mind the cost. I cannot believe that any management that is alive and well wants to take that road.

If that is not fully convincing, let us turn for a moment to the bank credit card.

The total number of bank credit card transactions is not as impressive as the trend of increase in transactions caused by bank credit cards. 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 increased by no less than 352 per cent. 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.

Profile of an Efficient Payments Mechanism

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.

The next question, then, is:

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:

-- Second, a lowered unit cost of bank services.

-- Third, a system based upon the on-line/real-time electronic transmission of information.

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

-- Fifth, the system should allow for delay in final settlement, at the customer's request and at his expense -- i.e., the customer would pay the cost of float, but, this being done, traditional credit usages could be continued.

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

-- Seventh, 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.

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

-- Finally, 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.

An Immediate Opportunity for Improvement

Small steps are being made in these directions, such as the introduction of electronic deposit of payroll checks, and pre-authorized payments by means of paperless entry.

However, well ahead of the electronic paperless payments mechanism there is an immediate opportunity to reduce check handling, by way of maximizing direct exchange of checks. This can be and is being approached by expanding existing clearinghouse capabilities, and, by establishing regional clearance centers.

These two types of changes are important steps toward a modern payments system, because they result in significantly improved 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;
- And, finally, better reserve account management for member banks.

In pursuit of this objective of reducing check handling, the Federal Reserve has 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.

Looking
Ahead

Toward the longer range goal of an electronic system, 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 Federal Reserve 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 could feed -- and from which banks could 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 individuals and businesses.

I am not among those who fear that reform of the payments system, or the widening of bank financial services 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. It is, rather: What financial system formations will best serve the public interest?

In my view a change in the financial system would not pass the test of public interest if it threatened the integrity or viability of the small bank. 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 broader bank financial services to the public, the small bank will be able to market in its own community services packaged by correspondent banks. The small bank will, consequently, be able to share in the profits of providing packages of financial services, without itself having to bear the expense of developing these automated services. I think small banks will also share in the benefits of a lower cost, modernized electronic payments settlements mechanism.

Banks serving the businesses and public of a state with the economic scope and impact of Ohio have both the resources and motivation of leadership. Consequently, I am certain that the banks of the Ohio Association will be among the first to make effective use of banking's new charter to expand and improve its financial services to the public, and to offer their customers a payments service that is faster, cheaper and more readily available.

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