

For release ON DELIVERY
Tuesday, June 10, 1975
Approximately 11 A.M., C.D.T.
(Noon, E.D.T)

A CHANGE IN CLIMATE FOR BANKING

Remarks of

GEORGE W. MITCHELL

Vice Chairman
Board of Governors
of the
Federal Reserve System

at the

Annual Convention
of the
Wisconsin Bankers Association

Milwaukee, Wisconsin

June 8-11, 1975

A CHANGE IN CLIMATE FOR BANKING

It would perhaps be most appropriate for me to be speaking to you today about the banking weather--a perennial topic of continuing interest to all of us and having to do with current monetary conditions, the flows of funds, the demand for credit and the implications for interest rates. I have chosen, however, to speculate on what lies ahead in the banking climate. I have done so because I believe many changes presently taking place in banking, and well within our view, are being misread as banking weather phenomena and not as fundamental changes in the climate of banking. The distinction is important in the formulation of both public and corporate policies; let me illustrate the point by analogy.

In recent years, research into our weather patterns and projections has stimulated scientific interest in the causes of long-run changes in the world's climate. Explorations below the surface of the oceans, into the jet streams in the upper atmosphere, the tilt of the earth's axis, and variations in its orbit are involved in search of the basic determinants of climate and weather. Inevitably, this activity has led to speculation that we may now be on the verge of entering another ice age or, equally disconcerting, a less-ice era. Whichever speculation turns out to become a reality, none of us will ever know because the projections run centuries beyond our life spans.

Similarly, what we could observe in the banking environment today involves far more than seasonal or cyclical changes in the "banking weather." The "banking climate" is being fundamentally altered too; and not at an "ice age" speed either. But our attention more often than not is absorbed by day-to-day fluctuations in banking conditions and the process of fundamental change is so gradual that even though its impact is cumulative it does not receive the substantial analytical or management attention it merits.

Obviously, I cannot, within the limits of my time this morning, identify the many forces of change gradually affecting the banking climate nor trace the nature of their impact. I can, however, briefly touch on certain changes, how they are affecting banking, the efforts that have been made by law or regulation to contain or channel the forces involved and the way in which it seems to me banking institutions, small and large, can cope with fundamental changes in their environment.

In some areas of the nation, the most troublesome and contentious feature of long-run change is what is often called the "structure" of banking--the number and size of banking organizations in a given State or banking market.

Sensitivity to structural characteristics is most apparent in the unit-banking States in the midwest. It is also evident in a few States where the acquisitions by multi-bank holding companies have been of such size and frequency as to incorporate into a holding

company affiliation within a few years a major share of a State's banking resources.

By and large, States along both the eastern and western seaboards, in the western intermountain area, and along the Canadian border have banking structures in which the presence of holding companies and State-wide branching institutions no longer raises the hackles of smaller institutions. In these areas most of the smaller institutions have learned how to compete successfully with the "big boys." In many of these States, concentration ratios for the very largest banks have fallen in recent years as their managements have tuned their growth objectives toward foreign business or, under the Bank Holding Company Act, toward "bank related" enterprises.

Although bank merger and acquisition activity has abated in recent months and although in well over half of the States the banking structure could be said to have become stable, between the Appalachians and the Rockies, branch and holding company banking are continuing sources of anxiety for many bankers.

Holding company bank acquisitions over the past ten years or so seem to me to have brought on significant changes in banking structure of at least 12 States. These States and the percentage of total State banking assets now (June 30, 1974) included in holding companies are: Alabama, 54; Colorado, 66; Florida, 74; Maine, 67; Massachusetts, 78; Missouri, 57; New Jersey, 43; New Mexico, 50; New York, 75; Tennessee, 49; Texas, 51; Virginia, 72. This activity

has had a lesser impact, up to now, in six additional States, as follows: Connecticut, 25; Iowa, 19; Maryland, 21; Michigan, 29; Ohio, 39; Wisconsin, 46.

The lull in acquisition activity over the past several months seems to be linked primarily to the low levels of bank stock prices, over-extended acquirers, and the current phase of the economic cycle. However, there may be technological forces at work as well. The rationale for some acquisitions has been to enter new markets; in other cases it is to achieve greater penetration of markets in which the acquirer already has a position. In Florida, for example, numerous acquisitions have resulted in patterns similar to branch office networks in State-wide branching States. Branches add substantially to operating costs but they are a means of increasing the size and penetration of the bank's market area.

It should be evident today that branching is not the only alternative method of supplying convenient banking service and thus raising a bank's marketing effectiveness. Trips to a banking office to make deposits, to get cash or to pay bills are no longer necessary. Direct deposit of salaries and other income payments is a reality; it will spread rapidly from now on. Teller machines have the capacity to perform the most essential functions bank offices serve. They can be located in shopping areas and at places of work; they are less costly to operate than branches. Other electronic equipment, such as POS terminals, have similar capabilities and involve truly spectacular operating savings.

POS-type devices in shopping areas, factories, office buildings and other places of work, when shared, entail minimal costs to financial institutions, being well within the reach of small as well as large banks in a given market area. Thus, a banking management looking into the future, as it must when the acquisition of a bank or branch is being considered, would be weighing the cost-effectiveness of access to customers by the use of electronic devices compared to the conventional mode of another "bricks-and-mortar" banking office.

The ironic possibility which comes to mind in considering the economics of providing basic banking services in the future is the marketing outlook for institutions in unit-banking States. Utilizing electronic terminal devices, it is not unreasonable to expect them to be able to realize the advantages of branching at a fraction of the cost of branch networks and be spared, to boot, the prospect of dismantling at least a portion of existing obsolete branching facilities. This is a serendipitous fallout of huge dimensions for several decades of non-conformance with the mainstream of structural change in U.S. banking. Or, perhaps, the day will come when the long-run foresight shown by the architects of banking structure in Illinois, Kansas, Nebraska, Oklahoma, and West Virginia will be acknowledged.

The latter view seems a bit farfetched, however, in light of the attempts now being made to prevent or hamper the use of electronic terminals by legislation or regulation. While I doubt public authorities will long bar the utilization of devices which

serve the public convenience, reduce the cost of banking service and are adaptable to the resources of both small and large banking organizations, it is possible that in the short run these tactics may have the effect of shunting portions of banking-type services to unregulated enterprises who are not so inhibited.

I have no doubt that some banks now continuously review their branching policies in light of the development of electronic substitutes for branches but the statistical evidence of such policies is hard to find. The banking system, according to the statistical record, continues to dilute its earnings with the proliferation of branch offices. While the number of banks in the United States has increased by only 7 per cent over the past 15 years, the number of branch offices has risen by 170 per cent. Relative to population, the number of persons per banking office is now less than 5,000-- for the first time. It was 7,500 15 years ago. It appears to me that the continued growth of banking offices indicates a clear misreading of the trend in the banking technology climate, a misreading that is likely to prove costly for some banking enterprises.

Another trend in the banking climate not clearly perceptible today but potentially of great importance is a shift in banking attitude toward consumer business. This involves the re-evaluation of consumers as both deposit and loan customers from the standpoint of institutional stability and profitability. Commercial banks have traditionally looked to businesses and in some degree governments as their prime customers. As money and capital markets have become

larger and more accessible, such customers have often found these markets more attractive than banks for the placement of funds or as a source of funds. Thus, a clientele which in the past could be regarded as providing a solid deposit and loan base has become increasingly sensitive to alternative money and capital market opportunities and has demonstrated steadily diminishing loyalty to its banking connections. Increasingly, such banking services as are needed by corporations are being paid for by fees rather than maintenance of deposit balances; while business demands on banks for loans are tending to concentrate in the tighter phases of general credit restraint. The consequence has been greater and greater bank dependence on interest-sensitive funds involving banking policies euphemistically referred to as "liability management."

As the shortcomings of liability management have emerged, some banks, in addition to those who have long been identified with consumer or retail operations, have begun to cultivate a larger consumer deposit and loan base. This market is comparatively stable, statistically predictable, comparatively insensitive to interest rate changes, and can be made profitable by the use of electronic processing and management. However, it is not an unoccupied area. Savings and loan associations, mutual savings banks, and credit unions have large and loyal consumer constituencies and are now seeking Congressional authority to expand both deposit and loan services so as to blanket the service possibilities for consumers, i.e., to become "full service" institutions for individuals.

It is possible that in the competitive struggle for the consumer market banks are going to encounter a dramatic and sudden change in banking climate. Competition with the thrift industry has been intense in most sections of the country for more than a decade. But that competition has been held in check by differences in statutory powers over deposit and lending activities and differential regulatory ceilings on time deposits. These statutory and regulatory restraints are rapidly being eroded, step by step, for a number of reasons. I will mention only a few as the process is quite involved.

First, I would point to developments external to regulated financial enterprises. I consider that electronic data processing technology and the structure of the service industry which has grown up around it have given thrift institutions a capability to do for themselves, or through non-bank contractors, certain vital processing operations formerly done by banks. Today, there are numbers of exceptionally skilled data handling concerns involved in deposit and money transfer data processing; many are outside of the banking industry. Some of these enterprises are cognizant of the enormous cost savings to be realized by putting together systems of data handling and transmission. As applied to thrift institutions, or banks, such systems can absorb the heavy front end costs and attain volumes capable of reducing dramatically the overall costs of deposit and money transfer operations. These realizable economies will have a compelling and overriding influence in the long run on relative shares in the consumer market enjoyed by banks, thrifts and other entities.

Another external influence affecting both banks and thrifts is the growing role of the retailing industry in the extension of consumer credit and in its aggressive development of many sophisticated electronic systems for its internal operations. The early introduction of machine language in these systems affords the opportunity, at least, to "flake off" certain depository and money related operations at costs which more elementary banking systems could not achieve. There is always the possibility that these capabilities would enable retailers to offer credit balances to their regular customers on highly advantageous terms.

Other external influences likely to impinge on market opportunities of banks and thrift institutions are the activities of bank and non-bank credit card companies, of equipment manufacturing subsidiaries and of wire, short wave or satellite transmission enterprises. The primary importance attaching to external forces is that they are not significantly held in check by the statutory and regulatory paraphernalia that banks and thrifts must live by.

Internal forces within the thrift and banking industries are sparked by competitive necessity in most instances but the innovative efforts of industry leaders are probably more determinative of the kind of climatic change in prospect. It would be interesting to trace step by step the way in which the thrift industry has steadily moved toward the expansion of its deposit and lending services but I doubt it would reveal much of which you are not already well aware.

The banking industry has been pushing for broader powers too, most recently for no differential between banks and thrifts on Individual Retirement Accounts deposits and for the authority to accept business corporation savings accounts.

I do want to comment briefly on the status of money transfer powers for thrifts and banks. When Congress authorized the NOW account experiment in Massachusetts and New Hampshire, I doubt anyone foresaw the impact that it would have--not in Massachusetts and New Hampshire but in the rest of the United States.

It was not long before non-Yankee ingenuity began offering package deals involving savings deposits and money transfer accounts. Some thrifts offered daily interest and transfer on any day by telephone advice into a checking account in a local bank of the account holder's choice up to bank closing hours. In response, banks have advertised, "Open a savings account with us with a \$200, \$300, or \$500 balance and we will open an unlimited free checking account for you with telephone transfers as needed from your savings account." Often this arrangement included other personal-type services, the length and character of which depended on the intensity of the competitive environment. Both banks and thrifts have moved beyond the NOW account stage.

As competition for personal accounts increases, several advantages for consumers are certain to be featured, among them savings accounts which will, in effect, have money transfer services adapted

to account holders' needs. The kinds of questions which remain to be resolved are the scope and variations in terms and flexibility-in-use for such accounts; the nature of thrift access to the existing clearing system and the universalization of reserve requirements. It seems to me that all of these issues can be negotiated between the banks and thrift industries and within a Congressional framework. In fact, I believe a great deal of that negotiation has already taken place, as exemplified in the proposals for access arrangements for ACHs. The most unfortunate prospect from either industry's standpoint would be a breakdown in communications between them and a failure to reach an equitable settlement. In such a case either or both industries would fail to serve consumer needs and at least some of their functions would be dispersed to non-depository concerns.

In brief, I am suggesting today that, as bankers, you ignore the oft repeated advice of Mills Lane to "Think small!" I do not do so lightly because Mills is an extraordinarily astute banker. But I have often known him to think big, too. To concentrate more of your attention on the viability of your institution three, five or ten years ahead is essential today. The banking climate then will be so different from what it is today, you cannot afford to neglect facing a permanent change in the weather.

In the past you may have been able to assume the competitive climate would be controlled in one way or another so that your operations would not be buffeted by competitive inroads into your markets.

This is a hazardous assumption for the years ahead. I believe Nebraska bankers, for example, faced a concrete problem of this kind--electronic terminal access--and made a decision looking to the future climate of their industry.

My final word has to do with the opportunity for smaller banks. I do not see that size of an institution presents any particular problem of adaption to the kind of changes in banking climate I have been talking about. It is undoubtedly true that economies of scale and specialization require that some banking operations will have to be contracted out because of their very nature. However, the essential feature of banking, as you well know, is the relationship between the banker and his customers. Customer allegiance can be retained by favorable service and cost differentials. It also depends, in the case of smaller banks, on a personal touch. That function cannot be performed by any electronic gadget. Its effective use depends on the banker himself.