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Some Observations on Banking in the 80's

Remarks by

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It is a pleasure to be here this afternoon to participate in this conference on Banking in the 80's. I plan to focus my remarks on what I believe to be one of the key challenges to you in the industry and to us as regulators this decade--that is, the need to develop flexible and adaptive management and regulatory policies which will enable the industry to navigate through some potentially difficult times as inflation is being brought under control. Such policies will be of critical importance if depository institutions are to meet successfully new sources of competition and to respond to rapidly changing conditions in financial markets.

As an economist, I am naturally inclined to look first to the economic factors in sorting out the underlying causes for the radical change in markets and structure now in process and that lie ahead. Not surprisingly the roots lie, as I have already alluded, in the inflation that has plagued our economy for the last decade and a half. We are all acutely aware of what inflation has done to the purchasing power of the dollar. But usually we are not so conscious of how deep and pervasive its dislocating effects have been. In fact, inflation has been the driving force behind much of the structural change observed in banking and finance over recent years.

Inflation, and the efforts to control it, have resulted in both the sharp run-up of interest rates over the past 15 years and the considerable increase in the cyclical variability of rates around that upward trend. Rising interest rates in the market, in turn, have repeatedly driven banks against deposit rate ceilings and other regulatory constraints, causing episodes of liquidity stress and savings disintermediation. The desire of depository financial institutions to maintain their deposit base and of their customers to achieve a fair market rate on their funds have spawned a host of financial innovations. These innovations include new financial instruments, such as CD's, MMC's, NOW accounts and rising rate notes; new technologies, such as EFT; new management concepts, such as liability and interest rate gap management; and finally, new institutional forms, such as the one-bank holding company. High market interest rates have also created economic opportunities for less regulated firms to offer financial services on more favorable terms and often at rates above Regulation Q ceilings, which are now in the process of being phased out.

The combination of these financial innovations and the entry and expansion of nondepository institutions into the financial service industry has radically affected the structure and functioning of financial markets and has significantly altered the array of financial services being provided. These developments are eroding the distinctions between banks and thrifts and have opened the door to so many different providers of financial services that it is now beginning to be difficult to tell which firms are and are not financial institutions.

I am particularly concerned with the risk implications of these financial innovations, which will require careful regulatory and supervisory oversight. There are abundant indications that financial institutions have become more risky and vulnerable to external shocks. First, the inflationary environment and efforts to control it have tended to increase the riskiness of bank and thrift assets because higher rates have added greatly to debt servicing burdens. The sharply rising trend of bankruptcy filings, both personal and business, reflects these strains as well as the difficulties of coping with inflation and a sluggish economy.

Second, this same inflationary environment has also exposed our depository institutions to sharp and unexpected changes in rates, making it exceedingly difficult to predict the costs of funding their investment portfolios. The increased competition from foreign banks, other financial and nonfinancial institutions, as well as the open market, also has goaded banks into more aggressive behavior to maintain market share. Meanwhile, efforts to maintain an adequate funding base, as core deposits have eroded, have brought fund raising and liability management to the fore. The end result has been to expand bank reliance on shorter-term interest-sensitive managed liabilities, which increases both interest rate and liquidity risk. The need to balance asset and liability maturities and costs to maintain profitability surely represents one of the more difficult and complicated management problems in banking today.

Third, the rapid expansion of large U.S. banks abroad and increased reliance on foreign sources of funds and earnings clearly illustrates that important components of the U.S. financial system are becoming more intertwined with that of the rest of the world. Exposure to political instability--such as the recent financial problem related to the Iranian crisis and the current problems in Poland--the effects of fluctuations in foreign economic conditions, the financing problems of LDC's in an oil-short world, and more volatile exchange rates are important factors suggesting that large U.S. banks have become increasingly vulnerable to external shocks.

Finally, the capital positions of large banks and thrifts, in particular, have declined, albeit for different reasons. But clearly these trends have been exacerbated by the fact that inflation has fueled ever-increasing demands for borrowed funds and bank credit. Accommodating these demands has tended to accelerate the growth in bank assets relative to their ability to generate capital internally or externally. Adoption of the holding company form of organization has facilitated this decline in capital through double leverage, adding further to the exposure of banking organizations if there is deterioration in asset quality--a risk that seems likely to continue as we strive to break the inflationary spiral.

As I have noted, the blurring of the distinctions between banks and thrifts has greatly enhanced competition, especially in the consumer financial services market. Perhaps more important, over the longer run, are the structural and competitive implications resulting from the growing involvement of non-depository firms in this market. Symptomatic are the money market mutual funds, whose phenominal growth to over $110 billion has captured the attention of us all. The funds offer ready access to accumulated balances through telephone transfers or payable-through drafts that serve as checks, and they enable even the small investor to earn something close to a market return on funds placed into a fairly diversified, very short term fixed asset portfolio. Because of the high yields currently available on such instruments, the funds have been able successfully to tap the time deposits of individuals and other relatively small depositors that traditionally have been locally limited. This breakdown of consumer dependence on local institutions for savings and other financial services may be one of the most important changes affecting the geographic scope of competition for funds in the years to come.

There are other important examples of nondepository institution entry into financial markets. Many large banks look with envy at the interstate office network of Merrill Lynch, which offers a package of consumer financial services in connection with its cash management plan having many attributes of an interest bearing transaction account. The plan includes the use of a Visa Card and checks issued through an Ohio bank that permits a customer to draw down funds invested in a money market mutual fund by creating what amounts to a daylight over-draft of a margin account.

Another recent and potentially important development has been the acquisition of "nonbank" banks by conglomerates and brokerage houses. For example, a finance company subsidiary of Gulf and Western recently acquired a small California bank that had divested its commercial loan portfolio. It thus technically was no longer a bank for the purposes of the Bank Holding Company Act, although in all other respects it remained a bank. This acquisition could serve as a model for further expansion for nonbanking conglomerates and possibly also for bank holding companies attempting to avoid the restriction on interstate bank acquisitions of the Douglas Amendment. In a similar vein, Shearson Loeb Rhodes has announced plans to acquire the Boston Safe Deposit & Trust Company, a deposit-taking trust company that also is not in the commercial loan business. And Prudential Insurance Company last month reached agreement to purchase the Bache Group, thus enabling the nation's largest insurance company, whose investment portfolio acquisitions have shortened significantly in recent years, to enter the brokerage business. Interestingly, Bache has two money market mutual funds totaling $3 billion. Thus, through such an acquisition, an insurance conglomerate could become increasingly competitive with banks, both in terms of competing for loan business and for investible funds.

In sum, the breadth of financial services beginning to be offered by nondepository institutions now appears to include a full range of both retail and wholesale business, including commercial finance, consumer and real estate lending, leasing, investment, insurance--and even payment services.

The developments in the payments area are particularly interesting. We have tended to be preoccupied with the pricing and other requirements mandated by the Monetary Control Act, and may be overlooking the fact that some of the major retailers--such as Wards, Penneys and Sears--have already established their own proprietary nationwide EFT systems. Sears has even undertaken a pilot project with the Credit Union National Association to accept credit union share drafts and process them electronically.

As I look forward into the decade, it seems clear to me that our first priority for the financial industry, as for the economy as a whole, must be to bring inflation within tolerable bounds, which in turn will offer the prospect of a sustained lower level of interest rates. But this will not be a quick, easy or painless task. Inflationary tendencies and expectations that have been incorporated into the system over the past decade and more are likely to be exceedingly difficult to reverse. Thus, I certainly cannot give any assurances that the near-term economic situation will be free from interest rate pressures and the other forces that have recently been giving our depository institutions so much difficulty.

In such an environment, the forces stimulating financial innovations and new entry into financial markets seem bound to persist. We are likely to continue to be faced with serious adjustments problems to such a changing environment. And there will undoubtedly be proposals to resolve, or at least to ease, these problems by extending the reach of regulation. Each situation must be judged on its own merits, of course, but we must all recognize that the fungibility of funds means that regulatory constraints will likely serve to intensify market oriented efforts to escape such regulations and increase the potential rewards to those that are successful.

I, for one, am convinced that the depository institutions will continue to be better, safer and more efficient providers of financial intermediation services than nonfinancial institutions. But in order to maintain their position in the financial services industry, it will be necessary to unwind those factors that inhibit the ability of the depositories to compete and adapt to changing economic conditions. This behooves us, in both law and regulation, to have a broader focus in implementing our policies, so that we take full account both of the immediate effects and the likely avoidance and other unintended responses that can be set in motion by our actions. It may mean, for example, that we should rely more on the market to help us regulate. It may also require a more competitive spirit by depository institutions themselves. Regulation should not be viewed as a permanent protection for the industry, because in the long run protective regulation is very likely to be self-defeating.

We must accept the principle that competitive forces will eventually prevail in the financial marketplace, rather than simply react to close new loopholes as they develop. I view this as the only effective way that our regulatory imperatives can be managed, and at the same time permit financial institutions the necessary flexibility to meet new competitors and survive in a rapidly changing environment. This is our challenge for the 80's and in it lies a fundamental key to maintaining a healthy, strong, efficient financial system.

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