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Bank Activities and Structure in the Coming Decade

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The Financial System in the Decade Ahead:

What Should Banks Do?

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I am pleased to be able to participate in today's discussions of the future of the banking system. In my remarks, I will present my thoughts on the future functions of banks, the delivery of banking services, and the evolution of the structure of the banking system. I would note that these are my personal views; other members of the Board may have other opinions.

Before launching into this discussion, I would emphasize that history reveals a strong tendency to overestimate the pace of change in the financial system. While many, if not all, of the changes we are talking about today will indeed take place, the question is: When will they occur?

I am reminded of former Federal Reserve Governor Mitchell, who, in the mid-1960s, predicted many of the changes in the payment system that are occurring today. He foresaw debit cards, stored value cards, home banking by computer, and electronic transfers. Unfortunately for Governor Mitchell's forecasting record, he was predicting these changes for the 1970s. Some of the developments he predicted haven't yet occurred. For example, stored value tickets, such as those used by the Washington, D.C. and San Francisco subway systems, have not caught on more widely in the U.S. However, according to recent press articles, VISA and others are developing a smart card which could be used for transactions that are normally conducted with cash. Such cards with multi-currency capabilities are beginning to be used in Europe.

A recent Business Week article contained forecasts of wonderful changes in the payment system. Once again, the imminent demise of checks was predicted. But, as the president of the largest check printing firm pointed out in a comment letter to Business Week, in spite of all these forecasts of new systems, the number of checks written in the United States continues to increase.

To take another example of a forecast gone a bit awry, when the states were considering interstate banking laws, smaller banks visualized Citicorp setting up shop next door. Along with a few other New York City and California banks, this was the bank to watch and fear. Who expanded? It's been the banks from Charlotte, North Carolina, Columbus, Ohio, Providence, Rhode Island, and Minneapolis, Minnesota.

As a final example, one stop shopping at financial supermarkets was another popular forecast that didn't work out. Remember how Sears Roebuck advertised for us to "buy our stocks where we bought our socks?" Now Sears is back to being a retailer again, and we won't be buying our stocks there anymore. The whole idea of bringing all financial services together at Sears or K-Mart seems to have fallen by the wayside.

Thus, being mindful of the dangers of forecasting more change than can be accommodated in the forecast period, I will limit my talk to commercial banking and its structure and keep the forecast horizon short.

The Role of the Commercial Bank

For a small number of banks, especially the largest banks, I believe life is going to change rapidly and drastically in the next decade. Some of these banks will be expanding on a geographic basis as they form multistate organizations or expand their international business. Many already have section 20 securities subsidiaries and will be active in off-balance sheet activities, such as derivatives. Other banks will be the technological innovators, and will be involved in the production of new financial products and delivery systems.

But, while the pace of change will be very rapid for this small group of large banks, for most banks, I don't think that the nature of commercial banking is going to change greatly in the next decade. Deposit-taking and lending will continue to be the core functions of their business, although improvements in technology and communications will speed data flows, and make business more competitive and more efficient. But, those of you who have studied banking over time know that things change slowly in this industry, at least for the vast majority of firms. In part, the slow pace of change is due to restrictive legislation; and, in part, it is due to the slow acceptance of change on the part of bankers and bank customers. Additionally, it takes time to accomplish the diffusion of new technology through an interconnected industry composed of thousands of firms.

Thus, most banks will continue to offer the depository and lending services that they have traditionally provided. For these banks, change will come at the margin. Fee income from the production of both traditional and new services will become more important, and these services will be separately priced and cost accounted to assess their bottom-line impact. More loans will be originated for sale into the secondary markets. Changes will assist in the more efficient use and allocation of capital.

For the longer run, I believe that banks should become the diversified financial service providers that Sears tried to become. Sears had the right idea, but they did not have the bank at the core of the organization. As the banking industry consolidates, it will be able to distribute products through the banks' office networks, as well as through the computer and telephone communications systems that will develop.

Such banks will provide a very wide range of financial services, both for consumers and for businesses. Their services will encompass all of those that Sears and the other financial conglomerates were envisioned to provide--banking, securities, insurance and real estate. Let me speak a little about each of these.

The banks' securities business is already expanding rapidly. Unrestricted underwriting powers are desirable, but it seems likely that only the largest banks will fully utilize these powers. Although there is a role for smaller banks in the local municipal markets and in the securitization of small business debt, I expect that most of these banks will concentrate their efforts on the distribution of investment products.

The rapid expansion of mutual fund sales through banks is a great example of the potential of a branch banking system. While more sophisticated investors buy no-load funds via mail and toll-free telephone numbers, most funds are sold on a retail basis by stockbrokers. But, since a majority of the population does not regularly deal with a broker, the banking system has a natural advantage in the distribution of mutual funds. Banks should become a prime vehicle for mutual fund distribution.

The sale of at least some lines of insurance is probably more important to banks than the distribution of mutual funds. An insurance brokerage line offers the bank the opportunity to gain a larger share of its customers' total financial business. Like the sale of mutual funds, this is a distribution activity that involves little risk of loss to the banks and can provide convenience to customers.

As most of you know, banks have long wanted to distribute insurance products. Those bank holding companies that have grandfathered insurance powers have found this to be a very profitable activity. Indeed, it is the most profitable of the nonbank activities permissible to bank holding companies. The Board has long advocated allowing banks to act as insurance agents. But, legislative reviews of the issue have not been supportive, and those opposed to the sale of insurance products by banks have placed significant federal statutory limitations on the banks.

Consistent with the one-stop financial service provider theory, a third logical service line for banks, but one which has received little attention in recent years, is real estate brokerage. Who is in a better position to act as a real estate broker than the local banker? The office network is in place, and financing and insurance could be provided along with the house. The bank could originate the loan and sell it into the secondary market, while retaining the service rights with already established bank customers. Naturally, existing real estate firms feel about the same as the insurance agents about allowing banks into their industry.

These new services could be tied together in a comprehensive package by the banks. When combined with financial planning and tax preparation, they would have consumer appeal, would provide all the financial services needed by the average consumer, and could be offered by nearly all banks.

In providing services for businesses, banks will only be able to compete if they are innovative and efficient. The banks' role in lending to large businesses has decreased as nonbank lenders have gained market share. Thus, it is even more important for the banks to retain the financial business of small and medium-sized firms. Much of this business was developed through local market contacts and high levels of service. These were combined with knowledge of their customers, their customers' business and their customers' markets. The local bankers knew the business of their local customers. Now, many of the local banks are being acquired by large interstate banks. If these new entrants cannot or do not provide the needed level of services to local business customers, the banking system will lose many of these businesses to the nonbank lenders.

Although I do not subscribe to the view that banking is a declining industry, many seem to hold this position. The declining industry issue is the theme of next month's annual bank structure conference at the Federal Reserve Bank of Chicago. Certainly there will be changes, and competitors will pick up some of the functions of banks. Whatever the changes, it is not axiomatic that banking, as we know it, has to have a certain share of the financial services industry in order to survive. Alternatively, perhaps the perceived decline of the banking industry is a measurement problem, and we should give some thought to new, more appropriate measures of the changing character of financial intermediation.

Although opportunities abound, in my own view, banks will do best by concentrating on expanding their consumer franchise while retaining their role in providing financial services to businesses. Naturally, they will encounter entrenched opposition as they attempt to expand into other activities. Most of the new activities that I have suggested are now either partially or totally off limits to banks. While public policy should not reserve a certain portion of the financial industry for the banking system, I do not believe the government should place competitive handicaps on banks.

<u>The Delivery of Banking Services</u>

Turning to the delivery of banking services, I think we can look forward to a gradual evolution of the public's payment habits. Most of the innovations that are being forecast will occur; they just probably won't occur as fast as some expect.

First, checks will eventually play a smaller role in the payments system. I won't go so far as to predict the year in which the number of checks will reach its peak. The big move away from checks will come when more bank customers find new systems easy and convenient to use, and when banks price this service to shift the full cost of processing checks to the check-writer. Thus, this transition will be driven by pricing decisions, as well as technological changes.

Second, the use of the ACH for the direct deposit of payroll checks and other regular payments will expand. However, debits to bank accounts for routine payments will grow more slowly, because many consumers are unwilling to give up any element of control over the outflow of funds from their checking account. Again, the pricing of debit card services, relative to other forms of payment, clearly affects the use of this innovation.

In the business sector, corporations are increasingly using electronic transfers to pay their suppliers, as well as their employees. Clearly, moves in this direction offer opportunities to reduce the number of checks written. But, my impression is that there is a long way to go in this area. The same is true for systems to bank at home by computer or telephone. I know that many past innovations in this area have been technologically attractive, but have failed to attract sufficient numbers of customers to be commercially successful. But, the passage of time will replace older people who are not comfortable with computers with younger people who have grown up with the technology.

These demographic changes, the spread of computers into more and more homes, and the decline in costs should lead eventually to a profitable home banking system.

Clearly, we will see a transition from a paper-based to an electronic system for the delivery of banking services. But, this is going to take some time.

The Consolidation of the Banking Industry: How Many Banks?

The clearest trend in the banking industry is the consolidation movement. The number of banking organizations continues to decline. There were 11,000 banking organizations in 1985; at year end 1993, there were only 8,300. While the absolute amount of change seems large, this represents only about a 3 percent per year decrease in the number of banking organizations. Failures accounted for some of the decline, but most is attributable to mergers and acquisitions. More consolidation is now legally possible because of the continued reduction in the barriers to in-state and interstate expansion.

The consolidation movement is not merely the absorption of small banks by large banks; it is also very obvious at the upper end of the size spectrum. For example, of the 100 largest banking organizations at mid-year 1985, 42 have already been acquired or will soon be acquired, assuming that all currently pending acquisitions are approved.

The effect of the consolidation movement is shown in the data on the share of total banking deposits held by the largest banks. For many years, the 100 largest banks held approximately 50 percent of total domestic banking deposits. Now, that percentage has increased to 64 percent.

The fact that this increase in concentration has occurred so early in the formation of interstate banking organizations is quite impressive. As yet, no firm is even close to establishing a nationwide office network. So far, only six bank holding companies have commercial bank subsidiaries in ten or more states. If a 14 percentage point increase in the national concentration of deposits is associated with achieving the current level of interstate banking, I would expect that the ultimate formation of a few truly nationwide banks will result in a much higher level of national concentration.

Does it make any difference if the top 100 come to hold 90 percent or more of commercial bank deposits? Probably not, as long as there is effective competition in local banking markets. The key is whether households and small businesses have access to a reasonable number of alternative sources of financial services from banks and other financial institutions.

Although there may eventually be a much higher concentration of deposits on the national level, there will probably still be many small banking institutions well into the future. While articles predicting doom for the small banks continue to appear, as they have for decades, there is still no evidence suggesting that small banks cannot continue to compete. Not everyone needs the services of a nationwide banking organization, and many customers prefer to deal with a small local bank where their business will be handled by the president of the organization. Correspondent banking relationships will expand to accommodate small banks' needs for specialized or complex banking services. The small banks, having a local base will act as a competitive check on the performance of the large firms.

Given the anticipated reduction in the number of organizations, one might question whether the antitrust laws would interfere with this consolidation. In general, I believe that they will not. First, especially during these early years of interstate banking, many mergers involve banks that are not operating in the same geographic markets. In many cases, they aren't even in the same states. For example, the merger of Society Corporation in Cleveland and KeyCorp in Albany formed a bank holding company with banks in 10 states. But, there was no geographic market overlap; Society was in Ohio, Michigan and Indiana, while Key was in seven other states ranging from Maine to Washington State. As long as there is no local market overlap, antitrust issues do not even arise. Second, the current guidelines for evaluating the competitive impact of bank mergers would not block most mergers. In nearly all major local banking markets, many banks could be acquired before the Justice Department merger guidelines would be violated.

The Consolidation of the Banking Industry: How Many Branches?

While the number of operating banks seems quite certain to decline, there is less certainty about the number of branches. Many of the forecasted changes in payment systems would lead to the conclusion that traditional brick and mortar branches will be less important in the future. The ATM performs many of the routine branch functions, and one bank has recently introduced a system for applying for loans through an ATM.

In addition, the massive branch closing programs that often follow mergers create the impression that the number of branches in the nation is declining. Actually, in spite of these closings, the number of operating branches nationwide has not declined, although the rate of increase is much lower than in earlier years.

Before accepting the idea that brick and mortar branches are obsolete, let me make a few points about the number of branches. First, the transition to interstate branch banking will convert a lot of banks to branches because many bank holding companies with banks in multiple states will convert their subsidiary banks to branches. In addition, there will be hundreds of mergers in the process of developing an interstate banking system; each of the acquired banks will probably become a branch of the acquiring bank. Finally, if interstate branch banking is allowed, bank holding companies may convert the offices of their nonbank subsidiaries into branches of their lead bank.

Even with the bank organizational changes we have experienced in recent years, we may not have reached a national equilibrium between the number of banks and the number of branch offices. In those states that have only recently liberalized their branching laws, there are probably still more banks and fewer branches than there will be in the long run. For example, as of year-end 1993, Illinois still had 958 banks and Texas still had 1,011 banks. There is every reason to expect that, especially in states such as these, the number of branches will continue to increase, while the number of banks declines.

Moreover, if banks are to differentiate themselves from money market mutual funds and other nonbank suppliers of financial services, much of the differentiation will be through the provision of local service offices. In fact, banks' branch networks will be key if banks are to become the major vendors of mutual funds and insurance. Those who forecast that branches will be replaced by ATMs are not thinking beyond the provision of basic banking services. ATMs are not going to sell insurance or mutual funds; it is personal contact with staff in a branch office that leads to those sales. Of course, since people don't buy insurance or mutual funds on a daily basis, there may be some room for the reduction of the number of branch offices. And, if the banks are not able to win legislative approval to provide additional services, the number of branches will be more likely to contract.

Conclusion

To summarize briefly, I have made a conservative forecast of the near term future of the banking industry. While this forecast does not suggest any really radical changes, I believe the change that is forecasted can be accommodated within a decade. I see a banking industry characterized for the most part by an essentially stable core business of deposit-taking and lending, supplemented by fee income from other sectors of the financial services industry -- insurance, securities, and real estate. The delivery systems will become more high tech and gradually move away from reliance on paper-based systems. The banking system will consolidate as a few organizations make continued acquisitions in the process of forming nationwide banks. While the number of banking organizations decreases, the number of branches will grow more slowly than in the past and may even contract. I will close with the caveat that there may be as yet unknown trends, technological innovations, or legal and regulatory changes that will render these visions of the future obsolete.

I thank you again for inviting me to be with you, and I appreciate your attention.

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