DEVELOPING TRENDS IN FINANCIAL SERVICES AND THEIR IMPACT ON THRIFTS

Remarks of
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It's a real pleasure for me to be here with you this morning at your annual stockholders' meeting. The fast pace of change and the intense level of competition that have become prevalent in today's financial service industry present challenges and opportunities to all financial institutions. I would like to talk about the forces underlying the changes we have witnessed and their implications for the future. I'll also have some comments on the impact of these changes on thrifts and the outlook for S&Ls in tomorrow's financial services industry.

Financial Services—Today Versus Yesterday

In order to see where the financial services industry is headed, I think it's a good idea to look around and see where we stand today compared with, say, the situation 10 years ago. If a banker, or the president of a thrift, whose work experience spanned the decades from the 1930s to the 1960s were, like Rip Van Winkle, to awaken today from a 20-year slumber, he would scarcely recognize his old profession. This old-timer would discover that while he was napping, market forces had changed the regulated world of the past into one that requires much more creativity and less adherence to procedures. Not many years ago, the world of depository institutions was surrounded by a fence posted liberally with "no trespassing" signs. Within that fence were walls that neatly segmented the various types of depository institutions. You could tell them apart a mile away: savings and loan associations could not offer checking accounts or anything resembling them. Neither could credit unions. Commercial lending was reserved strictly for bankers, but virtually all aspects of investment banking, including brokerage services, were off-limits to commercial banks.

The institutions within that fence were closely regulated. Rigid limitations restricted their freedom to establish branches or other offices, and banks' markets were generally confined to their own states or even to certain counties or regions within those states. Other inflexible restrictions regulated their ability to expand product lines. Savings and loan associations could not expand beyond the household mortgage market. Legal ceilings created a cap on the level of interest rates both banks and thrifts could pay on various kinds of deposits, dampening any competition that might emerge. During this long period of shelter from outside competition, financial institutions were almost guaranteed a profitable operation if they complied with regulations, did their arithmetic carefully, and offered a reasonable level of service to their depositors. Banks and thrifts did not chafe at their geographic limitations, or they did not mount pressures to remove such limitations, in large part because their local and state markets tended to provide good profits within the sheltered regulatory environment. Competition within the enclosure was muted, and potential competitors showed little desire to offer financial services and, thus, penetrate the regulatory fence. The friction introduced by interest ceilings made the situation appear stable for a while since these ceilings deterred nonbanking financial institutions from entering the markets traditionally dominated by banks, savings and loans, and credit unions.

Today, the situation is quite different. Some gaping holes have been torn through that once-protective fence. Many of the "no trespassing" signs have been trampled down, and the walls within that fence have been breached so often that many depositors forget they ever existed. The first major change to occur was in the type of businesses offering financial services. Beginning in 1973, Dreyfus, Merrill Lynch, and other nonbanking financial service companies began offering money market mutual funds. These interest-bearing accounts were a close substitute for bank deposits, and their popularity accelerated sharply in the latter half of the 1970s. The institutional expansion of financial service providers has not been limited to nonbanking financial companies. Even nonfinancial companies, such as Sears and the finance company subsidiaries of GM, GE, and other manufacturers, have played an increasing role in the line of commerce that was once the exclusive domain of banks. Such companies have expanded beyond their traditional roles of financing the products of their parents and are competing more and more in the markets once dominated by commercial banks.

Another major change was in the area of geographic expansion. Interstate banking has been spreading rapidly. By the end of this year we will find banks from about one-third of the states operating deposit-taking offices in at least 40 states. What's more, individual states have adopted laws that allow out-of-state banks to operate within their borders, further weakening geographic limitations. In all, about half the states have approved laws of this type, and over one-fifth have adopted regional reciprocal interstate banking laws. The latter are concentrated primarily in New England and the Southeast. The geographic expansion of savings and loans has advanced even farther. S&Ls have had the authority to expand within their states and across state lines for several years.

This geographic and institutional expansion of financial markets has occurred in tandem with product expansion. Institutions have bypassed the old restrictions on product lines. Banks and thrifts have the money market deposit account and the Super NOW account with which to compete against money market funds, and they have had some success in drawing back deposits formerly lost to nonbanking financial institutions. In addition, some banks offer discount brokerage services. Thrifts and credit unions offer checking accounts, and a myriad of new financial instruments and services are available to the consumer.

A final major difference between today's and yesterday's financial services industry pertains to the character or style of business. The industry seems to have lost some of its staid and stable character. In the last two years the number of bank failures has increased sharply, from about four per year in the sixties and about eight per year in the seventies to 48 in 1983 and 79 last year. These failures occurred at FDIC-insured commercial banks. More recently one of the nation's largest banks virtually failed, and only a month or so ago problems with S&Ls in Ohio alarmed depositors and financial markets here and abroad.

Forces of Change

How did all this happen? How and why did our traditionally conservative sector of the economy undergo such dramatic changes in so short a time? As I see it, three fundamental forces account for these changes. These are inflation, technology, and competition, with its attendant pressures for deregulation. Market forces and inflation deserve much of the credit—or blame, depending on your perspective—for interest-rate deregulation. The acceleration of inflation in the 1970s began to make traditional savings accounts, with their interest rate ceilings, look less appealing to depositors. Who could get excited about earning 5 1/2 percent when inflation was shrinking the buying power of deposits faster than the accrued interest increased their nominal value? Investors sought and found opportunities to earn more. Some unregulated and quite innovative businesses on the other side of the fence recognized the opportunity and conceived the money market fund.

Since those outside businesses were free of the regulations limiting banks and thrift institutions, they could offer depositors market rates of interest on funds placed with them. The result was inevitable: investors searching for more lucrative returns began to remove their deposits from depository institutions and to swell those money market funds. The fence that once seemed to shelter the regulated depositories quickly began to look more like a prison wall. Banks, savings and loans, and credit unions could not win at their own game. These competitive problems faced by traditional financial institutions generated momentum for the drive to liberalize government regulations. Many regulatory restrictions have been eliminated. Today, the deregulation of interest rates on deposits is virtually complete. Only passbook savings accounts, NOW accounts, and, of course, demand deposits are limited by interest ceilings. Ceilings on all interest-earning accounts will be eliminated on or before March 31, 1986.

Deregulation and innovation are also eroding barriers to interstate banking and product diversification. Although the legislative barriers to interstate banking still stand, banking across state lines has, nonetheless, emerged as a marketplace reality. Through a variety of strategems—including such devices as loan production offices, bank holding company subsidiaries, and the so-called "nonbank banks" and "nonthrift thrifts"—firms ranging from banks and S&Ls to supermarkets and general merchandisers are offering a mixture of financial services through offices scattered from the Atlantic to the Pacific. If we count the number of offices of foreign banks, Edge Act corporations, loan production offices, and other nonbanking subsidiaries of banks and bank holding companies as well as grandfathered interstate banking offices that are operating across state lines, the number of interstate offices offering various types of banking services totals almost 8,000! When you compare this figure to the number of commercial banks in the United States—a total of 15,000 with 55,000 offices engaged in full-service banking, you can see that we have an enormous amount of interstate banking already.

Some of the latest proliferation of interstate banking offices has occurred as a result of a Congressional loophole—the 4 (c) 8 clause of the Bank Holding Company Act, defining a bank as an institution that accepts deposits and makes commercial loans. Some financial corporations interpreted that clause to mean that subsidiaries which engage in one, but not both, of these two functions could legally offer such services across state lines. This either/or interpretation gave rise to the term "nonbank bank," with which you're all now quite familiar. I sometimes awaken from a dream, or perhaps a nightmare, in which a non-Fed Fed is trying to oversee these nonbank banks. After a lengthy period of legal wrangling, and after it became apparent that Congress was not likely to address the issue anytime soon, last fall the Comptroller of the Currency approved a number of long-pending applications for nonbank bank charters. Over 100 were subsequently approved by the Comptroller, the chief regulator of national banks. However, a suit by the Florida Independent Bankers Association challenging the jurisdiction of the Comptroller over nonbank entities has brought the former flood of approvals to a standstill, and the status of nonbank banks remains in legislative and judicial limbo.

Our legislators in Washington and in state capitals may debate the merits of these trends for a few more years, and they may influence the speed and course of interstate banking. Nonetheless, it is probably too late for legislators to stem the tide of interstate banking that is being propelled by market forces. The same is true of the judicial decisions pending. Early in 1985 the U.S. Supreme Court agreed to determine the constitutionality of state banking laws that limit interstate mergers to certain other states. The case before the Supreme Court was filed by Citicorp and New England Bancorp of New Haven, Connecticut. They are challenging the Federal Reserve Board's approval of mergers under state laws that limit such mergers to states participating in the New England regional interstate compact. That decision is of particular interest to us here in the Southeast, of course, but it will also be watched closely by legislators from other states such as Oregon, where regional interstate banking is under consideration. It could have implications for the merger of Florida's Sun Banks and Trust Company of Georgia as well since Citicorp has also filed suit in the U.S. Court of Appeals for the Second District in New York to block the SunTrust merger. It is difficult to predict when the Supreme Court's ruling may be issued, although present indications are that a decision could be forthcoming by late July. Even if the case were delayed until the fall term in October, however, interstate deposit taking would not necessarily slow.

At the same time that deteriorating legal barriers and intensifying competitive pressures have been transforming the financial services industry in dramatic ways, a technological revolution has been taking place in our payments system and, thereby, contributed significantly to changes in the nature of financial services. ATMs and other computerized services put customers and financial institutions in touch more quickly without the personnel and capital expense of bricks-and-mortar branches. Thus, the physical branch system of banks and S&Ls, one of their unique features, has become less significant. Moreover, banks' direct access to the payments clearing mechanism has lost some of its importance. Although checks and cash will remain important into the foreseeable future, paperless transactions involving wire transfers and automated clearinghouses are growing far more rapidly. Networks linking automated teller machines are offering consumers unprecedented convenience. For example, travelers a thousand miles from home can withdraw or borrow cash after regular business hours. When you stop to think of it, you cannot help but be amazed by the sweeping changes that have taken place. Those ahead may be still more amazing.

The Future of Financial Services

Where are financial services going, and what will it be like to do business in banks, savings and loans, and credit unions of the future? As I see it, four major forces will shape the course of tomorrow's financial services industry. These are macroeconomic growth, further increases in competition, regulatory changes, and even more exciting technological innovations. Clearly, macroeconomic factors will play an important and, I believe, positive role in determining the direction taken by banks, thrifts, and other financial institutions. Provided progress can be made toward lowering the very large federal budget deficit, the U.S. economy is likely to grow at a healthy pace over the next decade. Such growth should help mitigate problems such as the high incidence of failures. This expected expansion will also increase demand for all kinds of financial services, thereby creating an environment of growth and opportunities for financial institutions in general.

Since this sort of macroeconomic growth will require a stable as well as a highly developed and responsive financial system, we will probably experience some changes in the regulatory environment to ensure the continuing soundness of our financial system. Increases in bank capital ratios have already been enacted. We may see a change in deposit insurance. Critics of the present system have proposed deposit insurance fees based on risk, strict limits on payoffs for failed institutions, private co-insurance, and more intense supervision. The thrust of recommendations put forth by regulatory agencies other than the Federal Reserve is to place more risk on depositors. Under these various proposals, depositors would bear more of the cost of risk either because institutions would be charged for their riskiness and pass the added costs along to customers or because insurance coverage would be limited. In either case, more of the burden of assessing risk would fall on customers. None of the proposals is free from bugs; none is terribly attractive. I believe that there will be some reform, however. In addition, we may see the termination of state-based insurance systems. Recent events in Ohio have dramatized the fact that such systems are not truly workable over the long run.

Notwithstanding the probability of some regulatory reform, in my opinion, the major thrust will be toward further deregulation. Laws and regulations, no matter how well thought out, are proving to be flimsy indeed when pitted against market forces that push money flows into their most profitable uses. External competition will continue from Sears, Kroger, Merrill Lynch, and other nonbanking companies as well as from foreign institutions. Personally, I believe that Congress should close the nonbank bank and nonthrift thrift loopholes and provide a comprehensive statutory framework for interstate banking. Yet whatever happens, within five to seven years I feel banks will be able to operate across state lines nationwide. On the question of new powers, there needs to be serious consideration of the risks involved even though it is likely that banks will steadily broaden the services they offer.

In addition, consolidation of institutions will continue or even accelerate, although I doubt that financial services in this country will be dominated by a handful of large institutions as is the case in Canada and certain other developed countries. The type and size of America's financial institutions will remain varied because, beyond the range of $75-$100 million in assets, economies of scale apparently begin to diminish significantly. Furthermore, large institutions have not significantly penetrated the markets or slowed the growth of smaller ones when they have entered into direct competition. One reason is that small institutions can offer many of the same high volume services as large institutions through the vehicle of franchising, which enables small institutions to provide many of the low-cost services available at larger, more bureaucratic financial institutions without diminishing the special features that distinguish small institutions from larger ones.

Policy Implications

What can policymakers in Congress, in the Federal Home Loan Bank, and at the Federal Reserve do to ameliorate your troubled situation? I seriously doubt that more powers will be extended to thrifts to enhance their competitive position nor do I feel that such an extension would be appropriate. The implications of extensive real estate development activities by thrifts, already permitted by some states, is especially worrisome. Actually, we probably need closer and better supervision of current activities in view of the increased powers granted thrifts and the far greater complexity of today's financial services. One of the most important actions that Congressional policymakers could take would be to close some of the loopholes created in recent years. Such legislation, if sufficiently comprehensive, would reestablish the historical barrier that existed between finance and commerce without rolling back many of the advantages to the consumer and the economy in general that have occurred as the result of deregulation. Although I am a firm believer in deregulation in financial services, I believe that this barrier is one that needs to be kept in good repair in view of the critical role of finance in the functioning of any economy and the special safety net that has been constructed over the years for various segments of the financial services industry because of this key economic role. Clearly, these advantages and securities were never intended for the vast majority of commercial enterprises, yet the stability of our economic system would be jeopardized by removing them from the financial sector.

When I speak of more comprehensive legislation, the part that is most relevant to your situation is the nonbank bank loophole, which I mentioned earlier. I believe Congress should close this back door for commercial establishments to enter the financial services industry. However, to be effective, our representatives in Washington must also preclude the formation of nonthrift thrifts. If Congress fails to write such a provision into any legislative corrections to the existing loophole, commercial enterprises could well move headlong into the thrift industry, especially since it retains some regulatory advantages over banking. Finally, such legislation must provide some meaningful test of what constitutes a thrift. Simply dealing in the mortgage market should not qualify institutions for the regulatory advantages held by institutions that have extensive commitments in their portfolios to housing finance.

In addition to legislative action dealing specifically with financial services, I believe that the single most important policy direction that could be undertaken to help thrifts is to reduce the very large federal budget deficit. Large federal deficits tend to exert upward pressure on interest rates. We have felt that pressure in the current expansion only to a limited extent in traditionally credit-sensitive industries like housing because of the availability of foreign savings to help finance America's debt. About one-fourth of our net investment needs in 1984 were met by foreign sources of funds. However, this inflow of foreign funds entails a very high indirect cost for U.S. manufacturing and agriculture in that the high exchange rate of the dollar which accompanies this foreign investment makes it difficult for American businesses to export and to compete against cheaper foreign imports. Moreover, this level of foreign capital inflow is not likely to continue indefinitely. If it should diminish sharply, it's unlikely that Americans' savings habits could alter fast enough to maintain aggregate investment at the status quo ante. The effect of a sudden shift in portfolio preference away from the dollar would probably be felt by thrifts in the form of higher interest rates and a possible downturn in the housing industry. In contrast, if significant progress could be made to reduce the deficit, then inflationary expectations should wane. Moreover, since the deficit consumes the equivalent of over half our net domestic savings, a major source of upward pressure on interest rates would be lessened, thereby giving S&Ls more breathing room and more time to make the necessary adjustments to compete in tomorrow's competitive environment.

Conclusion

Let me conclude by reminding you of the challenges in the financial services industry today. In the case of thrifts, the paramount challenge is to steer a middle way toward diversification. That course lies between the Scylla of inaction and undue caution and the Charybdis of excessively risky ventures. Despite the sometimes intimidating nature of the developments taking place and the problems you confront, thrifts have greater opportunities than ever before as the financial services industry becomes less regulated, more diversified, and more dynamic. In moving to take advantage of those opportunities, I am hopeful that savings and loans, through diversification and prudent management, will find ways to survive and prosper, and in the process, I am sure, you will provide better financial services to the public.