BANKING OPPORTUNITIES FROM NOW TO THE TWENTY-FIRST CENTURY

Remarks of
Mr. Robert P. Forrestal
President
Federal Reserve Bank of Atlanta
to the Annual Convention of the
National Association of Urban Bankers
Miami, Florida
June 13, 1985

It's a real pleasure for me to be here with you this morning at your annual convention. 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 bankers everywhere. I would like to talk about the changes that are likely to occur in banking from now until the end of the century, including the types of services that probably will emerge and the kinds of skills that will be needed to succeed in banking. I'll also have some comments on the implications of these changes for urban bankers in tomorrow's financial services industry.

Financial Services—Today Versus Yesterday

In order to see where banking is headed, I think it's a good idea to look around and see where we stand today compared with, say, the situation 10 or 20 years ago. From the time of the Great Depression until quite recently competition among banks was restricted in three broad areas: geographic markets, products lines, and interest rates. Rigid limitations restricted banks' freedom to establish branches or other offices, and most banks' markets were generally confined to their own states or even to certain counties or regions within those states. Other restrictions, long thought to be inflexible, regulated their ability to expand product lines. Legal ceilings placed a cap on the level of interest rates banks could pay on various kinds of deposits, dampening any competition that might emerge.

Over the last decade the situation has changed considerably. Interest rate ceilings began to erode in the early 1970s, when savers discovered government securities, commercial paper, and other assets paying market rates and when nonbanking financial service companies began offering money market mutual funds. As you know, the popularity of these interest-bearing accounts, which in many respects serve as substitutes for bank deposits, accelerated sharply in the latter half of the 1970s. As banks and other depository institutions began to lose deposits permanently, or so it seemed, pressures mounted for deregulation of interest rate ceilings. Today, the deregulation of interest rates on deposits is virtually complete. Banks and thrifts now have money market deposit accounts and Super NOW accounts with which to compete against money market funds, and they have had considerable success in regaining deposits formerly lost to nonbank financial institutions. 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.

The waning of interest rate ceilings occurred along with some product expansion. Banks have found ways to offer discount brokerage services in this country and to underwrite insurance and securities abroad. Thrifts and credit unions offer transactions accounts and loans to consumers and businesses. Many banks are clamoring for powers to underwrite and sell insurance, securities, and real estate.

Although legislative barriers to full 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 already have a significant amount of what is essentially interstate banking.

What's more, many 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 more than one-fifth have adopted regional reciprocal interstate banking laws. These states are concentrated primarily in New England and the Southeast. Many thrifts are also marketing their services across state lines, not just in contiguous states but throughout the country, having purchased other, ailing thrifts under special legislation. By the end of next year, if nonbank banks win appeals from a pair of adverse decisions, we may find banks from about one-third of the states operating deposit-taking offices in at least 40 states.

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 the natural forces of competition. Inflation and its interaction with market forces deserve much of the credit—or blame, depending on your perspective—for interest-rate

deregulation. The acceleration of inflation in the 1970s made traditional savings accounts, with their interest rate ceilings, less appealing to depositors. The buying power of their deposits was shrinking faster than the interest earned on them. Investors sought and found opportunities to earn more lucrative returns outside traditional depository institutions. In response to this increased competition from outside the banking industry, banks and other depository institutions sought relief from interest rate ceilings. Large banks found ways of raising funds abroad, in an environment free of constraints, and others began to press for the deregulation that was finally enacted.

The national and international linking of markets that occurred, when combined with competition, also found a way to erode barriers to interstate banking and product diversification. Some of the latest proliferation of interstate banking offices has occurred as a result of an ambiguity in the Bank Holding Company Act, defining a bank as an institution that accepts deposits and makes commercial loans. Some bank holding companies interpreted that clause to mean that subsidiaries which engage in one, but not both, of these two functions could legally operate insured commercial banks in more than one state. Other, nonbank, firms have used the device to enter banking, thus combining banking with businesses such as insurance and securities underwiritng which have been prohibited to banks by other federal laws. 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 200 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 and a recent federal court ruling ruling in Atlanta disallowing the Fed's reluctant approval of a nonbank bank acquisition by a bank holding company have brought approvals for bank holding companies to a standstill. At this point, 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 effectively stem the tide of interstate banking that is being propelled by market forces. A few days ago the U.S. Supreme Court ruled that state banking laws limiting interstate mergers to certain other states are within the bounds of the constitution and federal banking statutes. The case before the Supreme Court had been filed by Citicorp and New England Bancorp of New Haven, Connecticut. They had challenged 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 has been 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.

As a result of this decision we will probably see further expansion of interstate banking, particularly by regional banks rather than by the large money center banks. The latter now are more limited to such legal devices as nonbank banks and to technical devices such as computers and telephone lines as means of widening their geographic

markets, and the future of nonbank banks rests largely with Congress and possibly the Supreme Court. Even if either of these countermands nonbank banks, though, I doubt that competitive pressures will rest on a plateau of regional interstate compacts. Rather, I would not be surprised to see the arena of competition shift to the product area. Large banks in New York, California, and elsewhere might lobby harder to be allowed to offer various services now deemed outside the proper realm of banking. The market forces that led to the erosion of interest rate ceilings will lead many institutions to look for ways to surmount remaining restraints on full nationwide competition, and I suspect that they will find avenues to do so.

At the same time that environmental and competitive pressures have been transforming the financial services industry, a technological revolution has been taking place in our payments system. This technological revolution has amplified these other changes taking place in the industry. 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. 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. Nonbank financial firms and bank credit card operations allow for immediate access to cash. Travelers several thousand of miles away from home can withdraw or borrow cash after regular business hours or 24 hours a day for that matter. 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 of the future? As I see it, four major forces will shape the course of tomorrow's financial services industry. These are the macroeconomic environment, continued pressures from 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 we have experienced in the past few years. This expected economic 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 are likely to see the termination of state-based insurance systems. Recent events in Ohio and Maryland 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, I believe there must be a 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 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 by buying services at wholesale and acting as distributor; this practice

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.

Finally, technological changes are certain to continue or even accelerate. Advances in computers will continue to make even more services available and economically feasible. Home banking through a family's personal computer is likely to prove popular as soon as technological advances bring prices down to a more affordable level and as children growing up with computers as both toys and educational tools become bank customers. Technology will also probably continue to erode the importance of branch systems while fostering the growth of alternatives that offer more convenience to the customer. One such alternative might be limited banking services in nontraditional locations like grocery stores. Another could be multiple services available through a single institution such as a general merchandiser or retail store.

It is hard to predict which services will prove technologically feasible and most popular. Yet, one thing is certain—new financial products and services are bound to proliferate in tomorrow's financial services industry. My confidence in this prediction is due to the fact that the changes we have seen in the past decade or two derive largely from competitive pressures, and these pressures are unlikely to abate through the end of this century. Moreover, the direction of recent technological innovation lends itself to the development of new financial products as a means of competing more effectively.

Tomorrow's Skills

These expected changes in banking suggest that the types of skills necessary for success will also continue to evolve. The profession of bankers has traditionally called for the skills of generalists. The reason for the predominance of this attribute was that bankers had to deal with people in so many walks of life and in such diverse economic circumstances. Bankers have always needed broad "people" skills to deal with a diverse clientele ranging from the young couple buying their first home to a growing business with expanding financial demands. However, in recent years technical skills have become increasingly important. To get ahead, bankers and banks have incorporated an enormous amount of new technology into their day-to-day activities. Computers are now part of almost every aspect of banking, and those bankers and banks who have been able to learn to use them and to see new applications have done well. In addition, products offered by the banking industry have become more complex and sophisticated. Consequently, financial and other analytical skills have become even more important than ever.

I see no change in this trend. Bankers will continue to need breadth of background and an understanding of human nature in all its diversity. Solutions that seem technically appealing and efficient can sometimes put off or even offend customers if they are made to feel like mere appendages of a machine. On the other hand, bankers need to have at their sides a "sharpened pencil" and the training and perseverance to use the analytical knowledge which this term implies. Competition has simply become too intense for bankers to skimp on technical, financial, and analytical skills.

of black banks have assests of $25 million or less although at least one is above $100 million in assets. However, unlike many smaller banks that achieve consistently strong financial performance by identifying and serving a profitable market niche, urban banks depend primarily on inner city minorities as their primary source of business. Since this segment of the population is economically disadvantaged to begin with and tends to suffer disproportionately during times of recession, it is understandable that black-owned banks tend to underperform relative to other small- to medium-sized institutions. Black-owned banks might improve their financial performance by working harder to earn and retain the loyalty of the rising number of affluent black households, who are moving into the suburbs, as well as that of black-owned businesses. However, money tends to flow to its most profitable use, and, by the same token, informed customers—both businesses and households—tend to look for the best products at the lowest prices, regardless of the social characteristics of the organization's owners. Thus, the future for most black bankers seems to lie primarily outside the fold of minority-owned banks.

Here, I believe, the future of black bankers generally seems brighter. In the last two decades black bankers in all financial institutions have made enormous strides in terms of professional advancement. The number of black bank officers has grown considerably in a relatively short time. The question on the mind of many black bankers today, though, is whether these gains will continue. A recent survey conducted by Ed Irons at Atlanta University revealed substantial frustration among black bankers with their current status as well as their career prospects. A number of those polled felt their chances of being promoted into the ranks of senior management were very poor. Other believe that, regardless of their technical know-how or educational qualifications,

they were being overlooked even for intermediate promotions because of remaining vestiges of exclusion from the inner circles of power.

What does the future hold for you and your colleagues as individuals in the banking industry? Are these feelings of frustrations misplaced, or do they signal looming losses of hard-won gains? In my opinion, your future, like that of aspiring bankers of all ethnic groups and races will be influenced heavily by the new spirit of competition that has come to dominate the financial services industry. In this more competitive environment there will be more emphasis than ever on recruiting the best, most innovative, and most efficient talent available, the talent that is likely to help a particular institution's profitability and growth. In this environment, the personnel skills I mentioned earlier apply equally to blacks as to all racial, ethnic, and gender groups. To get ahead in banking will require making a contribution, whether in the form of technical skills, financial analysis, or having the foresight and vision regarding new applications and products. In the years ahead all banks will need plenty of people with sharpened pencils in order to compete against both banks from other geographic areas and nonbanking financial institutions. Current demographics, however, may make things even more difficult for younger black bankers for a while. Because of the post-war baby-boom, the number of candidates for lower level officer jobs has swelled far beyond normal levels. This occurrence suggests that it will be harder for aspiring bank officers, both black and white, to achieve the promotions they desire and probably deserve. In this situation we must be sure that merit, and merit alone, determines who, among this much larger pool of qualified candidates, is promoted.

merger - cutting reduced demand for managers

If, as this recent survey suggests, subtle yet signficant vestiges of discrimination persist in our industry, then it is the responsibility of organizations such as the National

CRA. 6

Association of Urban Bankers to identify in specific terms the dimensions of this problem, to suggest remedies, and to petition decision makers in banking for redress of legitimate grievances. Obversely, it is the responsibility of those already in power to make sure that progress toward equitable treatment of minorities and other disadvantaged groups is not once again impeded. Their interest in doing so stems in part from basic economic incentives. Any business leader must attempt to conserve resources and allocate them as efficiently as possible. Since banks are highly labor-intensive, it makes good business sense to avoid underutilization of outstanding human resources and to avoid wasting its most precious assets in positions that do not bring out their fullest potential as individuals and members of the organization. Even more importantly, the interest of banking leaders should also stem from fundamental ethical considerations. They must guard against and extirpate whatever conscious and unconscious vestiges of discrimination still remain in the financial services industry.

Will there be a special role for black bankers? As society becomes more integrated, the need diminishes for special institutions dealing with those who have been victims of exclusion in the past. Thus, I feel the special role that black bankers in minority-owned banks is also likely to wane. However, there are important roles that black bankers will play in banking generally. First, black bankers such as many of you in this audience can serve as role models and mentors to those now entering and coming up through the ranks. Many of you have experienced trying situations during your careers in banking. Your insight and advice regarding how you triumphed over these circumstances is invaluable to a younger generation of urban bankers. In addition, as you develop more experience in the broad areas of banking and with the myriad of new financial instruments coming on stream, you could bring to black banks a greater wealth of experience than some have enjoyed in the past. This experience

CRA

could help such institutions improve their profitability and overall financial performance. Finally, you may offer your institutions a better understanding of how to market to a clientele which many banks have overlooked but whom nonbanking financial institutions and even nonfinancial companies are now attempting, with some success, to woo.

Conclusion

Let me conclude by reminding you of the challenges in the financial services industry today. In the case of urban banks, the paramount challenge is to steer a course toward diversification. For black bankers more generally the future will depend largely, as it does for all bankers, on how well you can adapt to today's more competitive banking environment, on how flexible you are in developing your skills to change with the times. Despite the sometimes intimidating nature of the developments taking place and the problems you confront, all banks and bankers 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 urban bankers, through diversification of your skills and a positive attitude toward today's opportunities, will find ways to prosper, and in the process, I am sure, you will provide better, more efficient financial services to the public at large.

profitable given S&L crisis and move toward more regulation!