

EXPANDING FINANCIAL SERVICES

**Remarks of Robert P. Forrestal, President
Federal Reserve Bank of Atlanta
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Forrestal

I am honored to be with you today to lead off your annual program on developments in the insurance industry. Like many of you, I am sometimes surprised to find the industry in which I have spent most of my professional life to be undergoing such rapid change, especially since this industry has long had a reputation, well-deserved or not, for conservatism and stability. My comments this morning will focus on the major developments taking place in the industry and why I find these changes, on the whole, beneficial.

Major Changes

Amidst all the individual changes that have been taking place in financial services, three broad areas of innovation stand out: declining institutional segmentation, increased geographic competition, and accelerating product expansion. In many respects, these changes are most apparent in the banking and thrift segments of the industry, but the patterns apply as well to insurance companies and other providers of financial services.

One of the most striking changes involves the breakdown of old institutional constraints and, ultimately, distinctions. Not many years ago a savings and loan, for example, was patently distinct from other financial institutions. It could not offer checking accounts or any near substitute. Neither could credit unions. Lending activity of thrifts was limited essentially to household mortgages. Commercial lending was off-limits to S&Ls and was reserved instead for commercial bankers. By the same token, commercial banks were precluded from all aspects of investment banking.

In contrast, today's S&Ls are allowed to invest part of their asset portfolio in commercial loans. They can also offer checking accounts, and credit unions can do the same under the rubric of share drafts. Commercial banks are offering a growing number of brokerage services. Over a decade ago nonbanking financial institutions such as Merrill Lynch and Dreyfus began moving into what was once the exclusive bailiwick of depository institutions. 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 markets once dominated by commercial banks.

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T In the insurance industry, we are seeing more companies move into real estate development, particularly by taking equity positions in some projects. In addition, at least one major insurance company has acquired an investment brokerage house, while a large investment firm has taken over an insurance company. Another insurance corporation sought to purchase a failing savings and loan institution, but the request was turned down by state authorities. Some insurance companies are offering IRAs. Sears has not only been making its presence felt in traditional banking markets. It is also moving toward providing a broad package of financial services that include insurance as well as brokerage of securities, real estate, and most recently its own bank credit card. Many banks have asked that it be permissible for them to offer insurance, and there is some evidence that such banking and insurance combinations would lower the risks and earnings variability of both type of businesses.

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Another dramatic development^y in financial services is the increase in geographic competition we have seen in the last few years. Not long ago most depository institutions were restricted to local or at most state markets. Many of these restrictions

date back to the Depression. Recently, though, interstate banking has been spreading rapidly. By the end of this year ¹⁹²⁰ we will find banks from about one-third of the states ^{will} 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.

It's not only banks and thrifts that are expanding geographically. 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. If you consider the various nonbank and nonthrift companies, you could say that nationwide banking is already here.

Although product innovation has been somewhat less dramatic than the breaking down of geographic and institutional barriers, in part because formal deregulation has not

progressed as far, no one can deny that the array of products and services being offered in today's financial services industry is expanding at an amazing rate. 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. Through some new powers they have been able to provide customers with a wider variety of services. Indeed, a myriad of new financial products are available to both the corporate and the individual consumer. These range from automated tellers that give more flexible access to basic financial services, such as making deposits and obtaining cash, to discount brokerage services. In order to deal with the competition that whole life policies in particular have been facing from group insurance, pension plans, and IRAs, life insurance companies have developed new, more diversified products that offer more investment features.

Why Have These Changes Occurred?

Why have these changes been taking place? What led to the dismantling of the highly segmented and regulated financial system that prevailed since the 1930s? Perhaps we should ask the question another way: why did it take so long for market forces to penetrate the financial services industry? When we look at it from this point of view, it becomes easier to understand why the arrangements that were created largely in the context of the Great Depression showed such longevity. Given the stable economic environment that prevailed during much of this period, it's not surprising that financial institutions did not chafe at their regulatory limits. After all, each type of institution enjoyed shelter from competition by virtue of this strict market segmentation. For instance, despite the restrictions faced by S&Ls on checking accounts and commercial loans, thrifts enjoyed a legally entrenched advantage over banks in the amount of interest they could pay on certain depository accounts. Interest rate ceilings sheltered banks as well from competition that might have arisen from non-depository institutions.

During this lengthy period of protective regulation, banks and thrifts were almost guaranteed a profitable operation as long as they complied with regulations, kept their books accurately, and offered a reasonable level of service to their customers.

This comfortable state of affairs began to disintegrate in the 1970s as the result of three fundamental forces--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. 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 payment of interest increased their nominal value? Investors sought and found opportunities to earn more. Some unregulated and quite innovative businesses 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.

Market forces are also generating pressures toward interstate banking. Some of the advances here have been made through the legislative process, particularly at the state level, which I have described. In addition, however, 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. As could be expected, 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.

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.

Assessment of Changes in Financial Services

As I mentioned at the outset, I feel that the changes that have been and are continuing to take place are for the most part beneficial. I am keenly aware of problems that some people associate with the less regulated, more competitive nature of today's financial services industry. 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. Last year one of the nation's largest banks virtually failed, and earlier this year problems with S&Ls in Ohio and Maryland alarmed depositors and financial markets here and abroad. Moreover, we have also witnessed several regulatory breaches by major banks and investment houses. Such acts have the potential to undermine the faith and confidence in our financial institutions that is so critical to the smooth functioning and continued stability of the financial system, as a whole.

Another area of concern is the move of some thrift institutions into real estate development. 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. In my view, this sort of product expansion has troubling implications for a segment of the financial services industry that is already beset by serious problems and challenges.

It's not just thrifts that I feel should be subject to such intensified supervision. Many banks and bank holding companies are in need of this too. Recognizing this need, the Federal Reserve System is now upgrading of its supervision and regulation capabilities. The thrust of this effort is to provide more frequent and more in-depth supervision of large and troubled institutions. This effort will entail the addition of staff

and changes in procedures to provide greater focus on areas such as liquidity and cash flow. We also hope to achieve better results by placing greater emphasis on communications of examination findings to the Boards of Directors of concerned institutions. In this way, those ultimately responsible for a financial institution's financial health should be more aware of underlying factors and better able to see that appropriate actions are taken.

On the question of new powers generally, I believe there needs to be serious consideration of the risks involved even though it is likely that financial institutions of all kinds will steadily broaden the services they offer. In particular, I believe that Congress should close the nonbank bank and nonthrift thrift loopholes and provide a comprehensive statutory framework for interstate banking. 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 safeguards 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.

Despite these caveats, I feel these changes have been and will continue to be good for the economy and for the consumer. Consumers are benefiting from a wider array of services, and we have far more options for earning income on both our savings and the funds to which we need ready access. Generally, increased competitive should put

downward pressures on the cost of financial services. The trend toward interstate banking is fostering the flow of capital to its most productive and profitable use in markets that are freer of artificial geographic and institutional barriers.

Outlook and Implications

As I see it, there is every reason to expect that the rapid pace of change and expansion in the financial services industry will continue into the foreseeable future. I doubt if we will see any significant retrenchment in the direction of re-regulation. It's true that we may 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 also see a change in deposit insurance. In addition, we are seeing the termination of state-based insurance systems. Recent events 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. Within five to seven years I feel banks will be able to operate across state lines nationwide. 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, and other nonfinancial companies as well as from foreign institutions. It seems likely that the competition among banks, thrifts, and even insurance companies will continue to intensify, and the probability of further integration of financial services among such institutions is not remote, although this trend is unlikely to spell the disappearance of small institutions.

Conclusion

Let me conclude where I began. I am excited to be a part of today's rapidly changing and expanding financial services industry. Although change itself can often be intimidating, I am confident that those individuals and organizations that face this challenge positively will find ways to prosper. In the process, our economy is certain to benefit from the more efficient and flexible financial system that is developing.

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