BANKING ON THE EVE OF THE EIGHTIES-- A TIME FOR STRATEGIC THINKING

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Banking on the Eve of the Eighties -- A Time for Strategic Thinking

You chose a timely subject for your conference: "Banking in the Eighties!" The decade ahead promises more challenges and frustrations and certainly more opportunities than any like period in my memory.

Inflation and the Economy

The Eighties, I believe, will be characterized by a continuation of our number one economic problem--inflation. You know its effects: customers require more credit to finance the same physical volume; operational costs are difficult to control; funds become much more expensive; and most interest rates, after adjustment for expected inflation, are quite low despite high yields.

The crucial questions are: how do we bring the rate of price increase down to a lower level? and what are the consequences for bankers? We all hope for a "soft landing"--that price increases can be brought to tolerable levels without a damaging recession, high unemployment, and resulting social or political upheaval.

Changed Environment--Escalation of Competition

Even with continuing inflation, we must face a changing institutional environment, probable features of which will be escalating competition and evolving legislation and regulation.

Certainly you already endure ample competition. Savings and loan associations and credit unions are competing effectively for savings

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deposits. They are beginning to offer checking services in the form of share drafts and other "payable through" instruments. Aided in part by the authorization of NOW accounts, thrift institutions have made serious inroads into the market share of commercial banks in the Northeast.

In recent days Sears, Roebuck & Co. announced plans to begin next year the sale of securities in denominations as low as $1,000 to the 26-million customers on its charge account list. The notes will mature from 9 months to 10 years and interest rates will probably be higher than those available at banks or thrift institutions. The Sears offer alone might not be significant were it not for the potential impact of similar moves by other large corporations.

International banks are pursuing opportunities in our region; many banks have opened loan production offices. Consumer credit affiliates have expanded into your market areas as have finance affiliates and mortgage companies. Also, a variety of investment advisory services are more visible. In this form of increased competition, the absence of brick and mortar structures is significant: a financial institution's presence can be adequately represented by a single calling officer.

I look for these various competitive sources to pose even more threat in the years ahead.

<u>Thrifts</u>

The most obvious source of increased competition for commercial banks are the nonbank thrift institutions. Very likely third-party payment powers will eventually be extended to all depository

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institutions. They may be empowered to extend additional kinds of credit. In combination, this will represent powerful competition to banks across the country both for deposits and for lending outlets. Perhaps aided by the Regulation Q differential during the last seven years, the rate of deposit growth at thrifts has outstripped that of all commercial banks by a factor of 2 to 1.

Foreign Banks

Another potent source of competition is likely to come from foreign banks. As of May 1978, about 230 foreign bank branches and agencies were operating in this country. Foreign banking institutions continue to charter or purchase domestic banks in growing numbers. They have grown more rapidly than the domestic banks with which they compete.

Foreign bank operations in the U. S. were started principally to finance the foreign trade and business of their home countries. However, they rapidly diversified into the domestic banking business, particularly by making low risk, highly profitable business loans to U. S. corporations. In addition, foreign branches have experienced a rapid growth in deposits from U. S. customers, mostly corporate depositors. Occasionally, the prime rate has lost some of its punch because of foreign competition where terms are quoted on a LIBOR (London Inter Bank Offer Rate) rate plus a percentage.

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Branching Ramifications and the McFadden Act

In 1974, with a view toward eliminating inequities, the Federal Reserve proposed to the Congress legislation dealing with U. S. activities of foreign banks. Such efforts probably contributed to passage of the International Banking Act of 1978.

The International Banking Act will go a long way toward equalizing the basis on which domestic and foreign banks compete. The Act is a prime example of the dramatic ways in which laws and regulations will have to change to accommodate the equally dramatic changes in the financial industry itself. Specifically, the Act requires the President, in consultation with the banking agencies, to review the McFadden Act and report to the Congress by September 1979, on the impact it has on the nation's banking structure.

The McFadden Act limits the branching powers of national banks to those provided under state laws. In contrast, the branching powers of Federally-chartered thrift institutions have not been limited by statute (although they have been limited somewhat by Federal Home Loan Bank Board regulation). Granting the thrifts' expanded powers, such as consumer loans and nationwide NOW accounts, would result in a further substantial competitive disadvantage for commercial banks.

Liberalization of state branching restrictions and the provisions of the McFadden Act would reduce competitive inequities; however, competition in the industry could become even more intense. Outside

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banking institutions might open their own offices in other regions. Or, if allowed to expand through subsidiaries of a holding company, they just might purchase existing institutions outright.

Still, the branching question may soon become a moot point. The deployment of terminals nationwide may be authorized within a few years. Terminals of the increasingly "smart" variety (for example, those that open accounts and accept loan applications) would cause retail brick and mortar branches to become less important in the long run. Further, limited-function facilities, such as loan production offices or consumer finance companies wholly owned by the parent bank holding company, coupled with "smart terminals," could be de facto nationwide branching.

The industry seems to be moving toward expanded interstate competition. Bank holding companies currently engage in "nonbanking" activities across state lines. Banks have multi-state loan production offices. Electronic funds transfer has increased dramatically the ease with which service facilities can be placed in remote locations. In the end, the rule-makers may be forced to accommodate these changes, not stand in their way.

Membership Bill

Still another element in the banking environment of the 1980's is legislation proposed to shore up the Federal Reserve System's eroding

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membership base. A total of 551 banks have withdrawn from membership over the past ten years. Even though many of the banks withdrawing from the System are small, there is a growing trend among larger member banks to become nonmembers. Fifteen of the 69 banks that left the Federal Reserve in 1977 had deposits in excess of $100 million. Because of the decline in membership, the proportion of total commercial bank deposits held by member banks was reduced by 10 percentage points, to about 72 percent in the nation, and about 60 percent in this District.

Congress is now considering two similar bills introduced by Senator Proxmire and by Congressman Reuss--the chairmen of the Senate and House Banking committees. These bills would require both member and nonmember banks having deposits in excess of a certain exemption to meet Federal reserve requirements. The exemption is $50 million for savings and time deposits in the House bill. The Senate bill uses a $40 million exemption level. Other depository institutions--including savings and loan associations and credit unions--would be required to maintain reserves if they have transaction accounts in excess of the exemption level.

Another feature of this legislation proposes the requirement of pricing of Federal Reserve services. Of the two, the Proxmire bill has the more explicit requirements. It requires the Federal Reserve to publish a set of pricing principles and a proposed fee schedule by July 1, 1979.

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Some banks may conclude, after analyzing the Federal Reserve's pricing schedule, that they can offer some services to other banks at cheaper rates. If so, this represents a new marketing opportunity. Also, the pricing of check and Automated Clearing House payments may accelerate the long-awaited move to electronic payments systems. The importance this legislation has for banking in the 1980's should not be underrated.

Congress and Consumerism

Another aspect of the changing regulatory dilemma is that agencies really do not act on their own initiative. The agencies genuinely try to enact what they believe to be the will of Congress. So, in order to anticipate further regulatory reactions, we need to examine the action--and the direction--of the Congress.

The 96th Congress is reputed to be more conservative than its predecessors, possibly more in tune with the public. Congress, nevertheless, seems enamored with social legislation, an area of political appeal with little direct outlay of public funds.

Even if Congress did nothing else--which many of us believe might be an appealing alternative--a large volume of social legislation is already with us. It seems unlikely that any appreciable part of this will be withdrawn.

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Regulation of Interest Rates

Some of the present regulations may of course change appreciably. A prime candidate for possible modification in the next decade is Regulation Q. Any changes in it probably will take place in the context of other changes--expansion of NOW accounts, for example. It seems likely, however, that any modification to Q will heighten competition between banks and other institutions. We might see the demise of the savings account as it now exists. We might also see the emergence of time deposits based more flexibly than now on the length of time for which the contract is made. Reductions in minimum requirements might well take place. Could this mean that the decades-old prohibition of payment of interest on demand deposits will pass into antiquity?

The Problem of Capital Adequacy

One other regulatory issue that is likely to be with us in the Eighties is the matter of capital adequacy. It appears certain that bank supervisory agencies will focus on capital adequacy as an integral part of bank evaluation. Sources of capital available to banks for growth in assets and liabilities are likely to be critical. This brings us to the "bottom line" implication of my remarks about the competition, regulation, and inflation environment.

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Pressure on Management of Funds

The "bottom line" is the increased premium that will attach to management of funds and pricing of services in order to attain a reasonable return on investment. Bank profits must increase if meaningful amounts of new capital are to be available either from retained earnings or sale of equity shares. Clearly the emphasis on funds management and pricing strategy will have to be a central goal for bankers in the years ahead.

With respect to the source of funds, my view is that increased competition among banks and between banks and other financial institutions will intensify the search for new funds. A successful pursuit in our struggle against inflation would not mean a reduction in the relatively high interest rates in the near term. This will further compound the impact of increased competition for funds. In any event, "managed liabilities" and "marginal cost of funds" are terms that will be around for a long time.

With the tendency of your "raw material"--deposits--to be high in cost and the sources competitive, pricing your services becomes critical. The analysis of customer accounts takes on added meaning to ensure something equivalent to full-cost pricing and a return on investment. You will need to look carefully at your non-asset related income, income from fees and special service charges. The coming

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competitive thrust in pricing is to put each area on its own as a profit center. Emphasizing fee income has a peculiar advantage in that it does not depend on increases in deposits or assets, and hence does not require additional capital.

Developing a Strategy to Cope

The decade of the Seventies has been characterized by rapidly changing forces that affected your ability to compete, the nature of your competition, and your ability to earn reasonable returns on investment. Looking ahead to the Eighties, it is my belief that the environmental forces may be a good deal more threatening. Competition will escalate further. But on the plus side, the competitors will be on a more equitable footing as financial institutions become more similar in terms of services offered.

Sizing up the market environment in the years ahead is less of a problem than determining what to do about it.

In my opinion, every banker in the room will need to do a lot of homework and critical analysis as he develops a strategy for coping with the challenging environment.

As a starting point, each bank should pause to assess itself. What kind of institution is it? What services is it selling? Who are its customers and what do they really demand? Who are your competitors? What unique advantages does your bank have in providing

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services compared with your competitors and how might these advantages be exploited?

All I am suggesting is the need to develop a strategic plan to guide your bank in coping with the changing environment during the years ahead. Evidently some banks are well along in developing their strategies. One example may be the decision by Bankers Trust to sell its consumer banking business to the Bank of Montreal, thus concentrating on wholesale banking. A few other large banks have apparently decided to abandon the check processing and accounting areas to specialized data processing firms.

Adapting to our new environment will be a challenge for all of us--bankers, bank customers, and perhaps especially, central bankers. If we consider the opportunities available to us through embracing and charting constructive change, rather than resisting it, then we can meet the challenge. I believe we will do just that.

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