Banking in 1974 and Beyond

Remarks by Robert P. Mayo, President
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Speculation as to the future course of banking seems difficult enough even on a day-to-day basis, let alone years and decades into the future. Except for those few individuals and institutions actively working on their development, who could have predicted much in advance the initiation and subsequent widespread use of such banking services as bank credit cards and check credit plans to attract personal bank customers and of lock box plans and large certificates of deposit to attract corporate customers? The ingenuity of bankers in perceiving needs of their customers and developing efficient ways of satisfying these needs--even if it requires challenging some Federal Reserve regulations--continues to impress me.

What I hope to do this evening is to offer some perspective derived from the developments in banking in the recent past, a few projections based on the admittedly questionable assumption that these developments can be extrapolated over the years to come, and some thoughts as to how bankers might most appropriately handle the coming events. I have selected three areas at which to direct my remarks: the economic environment, the impact of technological change, and changes in financial structure and regulation.

The Economic Environment. There is little doubt that changes in the economic environment have had important consequences for commercial

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banking and that they will continue to do so in the future. The period of economic expansion which got underway in 1961 and reached its peak toward the end of 1969 was the longest period of continued economic growth in our history. Commercial banks participated actively in this growth. From the end of 1961 to the end of 1969, total loans and investments at all commercial banks almost doubled, and that was true of Seventh Federal Reserve District banks as well. Some may look back on this period as the "good old days" since, by most measures, this was a period of remarkable economic performance except for the serious inflation in its later years.

We should not forget, however, that it was economic policies of the past that have been very influential in bringing the economy to where it is today. You will recall that in the early 1960s the economy was characterized by stable prices but an unemployment rate of about 5 1/2 percent. Later in the decade, the demands of the Vietnam war, with its pressures on manpower and other productive resources, and the initiation of new government social programs reduced the unemployment rate to 3 1/2 percent by the year 1969. At the same time, however, these expansionary policies sowed the seeds of the inflationary cycle that we find ourselves in today.

Immediately after the Nixon Administration took office in 1969, it pinpointed inflation as the primary economic problem. It implemented a restrictive fiscal policy by asking for extension of the surtax, and calling for restraint in federal expenditures. Congress, with minor changes in detail, acted on the President's recommendations. At the same time, the Federal Reserve System reinforced fiscal restraint with a moderately restrictive monetary policy. These steps--which together

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were referred to as a policy of "gradualism"--were taken on the assumption that inflation could be reduced to an acceptable rate without increasing unemployment to a level which would produce significant hardship. It was realized that this would be a lengthy process. Yet I know of no economist, in or out of government, who did not underestimate at the time the momentum built into the trends of both prices and wages.

Despite the policy steps that were initiated in 1969--and I want to emphasize that these appeared to be rather strong policy measures at the time--the problem of price inflation showed only slight signs of abatement during 1969 and on through 1970. The rate of increase in consumer prices declined from 6.1 percent between December 1968 and December 1969 to 5.5 percent the following year. The costs of achieving this slowing of price increase became more and more evident during 1970 and 1971 as the rate of unemployment fluctuated around 6 percent and averaged more than 2 percent above the recent low of 3 1/2 percent reached in 1969.

Although monetary policy eased early in 1971, the economy failed to respond to monetary stimulation quickly or in the manner desired. The unemployment rate declined only slightly during 1971 and as pressures on prices began building, the President intervened dramatically on August 15, 1971 with the announcement of the wage/price freeze. Whether the subsequent freezes and phases have been successful in moving the economy closer to the apparently incompatible objectives of full employment and price stability is currently being debated heatedly and will be the subject of intensive study for years to come.

Criticisms stemming from recent economic and policy developments point out two interrelated attitudes. First is that we expect the U. S. economy to be well-behaved. Congress and the public generally believe,

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for example, that full employment and price stability are somehow achievable simultaneously. Second, to the extent the economy fails to meet these expectations, policymakers are expected to intervene directly in an effort to bring about desired performance.

The economic policies undertaken to achieve these goals have had significant consequences for commercial bankers. In 1966, and again in 1969 and 1973, a monetary policy aimed at slowing an overheated economy put heavy pressure on commercial bankers. Probably the most visible form of pressure came in the form of disintermediation. Market interest rates rose and funds flowed from deposit-type institutions directly into market instruments. Financial institutions aggressively sought funds from nondeposit sources and actively expanded those types of deposits exempted from interest rate ceilings. In addition to disintermediation, the most recent period of monetary stringency has been accompanied by administrative action to keep the prime rate from rising as high as it otherwise might have. The now-famous "two-tier prime rate" is an adjunct to these efforts.

Given the recent increase in the requirement for these types of policy actions, may we infer that the pace of such events will accelerate as we approach 1980 and beyond or might there be some decline in the frequency with which we are required to resort to stringent monetary policies or to direct intervention?

I think the answer to this question depends on our expectations for the performance of our economy and how much we have learned from recent economic developments. If nothing else comes from our recent economic experience, I hope that it makes us face up to the inescapable fact that the pursuit of more than one economic goal involves trade-offs.

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We may make progress in achieving one goal but only at the expense of another. If we recognize this one present fact, then banking in the years ahead may be less hectic than in 1973 and prior years (I hope).

Technological Change. Another area of significant interest and importance to commercial banks and the Federal Reserve System is the role technology is playing in commercial banking and related industries and the possibility that we have only seen the tip of the iceberg in these developments. A specific area of great concern to the Federal Reserve System in recent years has been the payments mechanism. As the volume of checks processed continued to grow and as other industries encountered problems in processing increasing volumes of paper documents, the Federal Reserve System embarked on a program designed to insure the viability of the conventional check system and also to move ahead to employ advanced technology in the payments area where feasible and desirable.

There are several results of these efforts to date. The Federal Reserve Bank of Chicago and other Reserve banks have established Federal Reserve Offices in major cities which previously had no Federal Reserve Office to process checks more efficiently and better serve local banks. Indianapolis is a good illustration. The direct linkage of commercial banks that are heavy users of the Federal Reserve telecommunications network with their Federal Reserve bank to effectuate wire transfers of funds more efficiently and the elimination of the charge for wire transfers of funds over $1,000 are moves designed to reduce the costs and encourage the use of electronic technology in making money transfers. The involvement of Federal Reserve banks in automated clearing houses and other electronic funds transfer systems and the provision of the capability to carry and trade in government and agency securities in book-entry

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form rather than dealing in physical securities are further evidence of our involvement and commitment in providing the best possible services to commercial banks and the public.

As intended, the direct involvement of the Federal Reserve System in these technological improvements is in the area of bank-to-bank interface. But to the extent that such involvement reduces costs or improves service to member banks, the nonbanking public will likely benefit. More aggressive commercial banks will offer new or improved services based on improvements made by the Federal Reserve and, in the competitive struggle to maintain their market shares, other banks will follow.

But possibly even more important from the standpoint of the impact on commercial banking has been the adaptation of new technology and new techniques by commercial banks, quite apart from efforts of the Federal Reserve. I have in mind here such innovations as the use of bank credit cards and check credit plans to encourage and make consumer loans; the payment of daily interest and the issuance of large negotiable CDs to attract and hold time and savings deposits; and, the consulting services provided corporate and other customers regarding improved cash management techniques based on new technology.

An important effect of such efforts by bankers has been to encourage both corporate and business customers to reduce demand deposit balances below what might otherwise have prevailed. Consumers having credit readily available at the point of sale have less need to rely on cash or demand deposit balances to make purchases. And, since purchases can be accumulated and paid for all at once, credits and debits to non-interest-bearing demand deposits can be more closely synchronized,

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resulting in lower average demand deposit balances. Payment of daily interest on savings deposits makes them an attractive alternative to holding a demand deposit and provides further incentive for bank customers to economize on demand balances in favor of time balances. For corporations, higher market interest rates and a greater awareness of the opportunity costs of holding idle balances provide sufficient incentive for them to seek out those banking institutions affording them the best opportunity for effective cash management. The discipline of the marketplace insures that when one bank offers an attractive service others will follow.

But what about the future? Looming on the horizon is the major adaptation of electronics that will bring us closer to "checkless" or "cashless" society. Some are skeptical about such a development. To others it is a dream. But we cannot afford to ignore the fact that it already has been the subject of successful experimentation. The potential cost savings that are projected for certain facets of electronic funds transfer systems appear to be sufficient incentive to compel further experimentation and development. As a matter of fact, I understand that several of your Indianapolis banks seized the opportunity some time ago and have a rather extensive and sophisticated direct deposit payroll system in operation with several major local employers. To the extent that making money transfers electronically gains momentum, costs of making money transfers will be reduced and the ability to further synchronize payments and receipts will be improved. Given such eventualities, demand deposit balances will continue to become relatively less and less significant financial assets to the public.

If banks are to continue to grow in this environment, bank management strategies must be directed at extending the use of time and savings

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deposits and possibly developing new sources of funds. And, depending on competitive pressures and preferences of bank customers, bank management may have to engage in more explicit pricing of various banking services rather than relying on demand deposit balances to "pay" for services rendered.

Financial Structure and Regulation. A third area of importance to banking in 1974 and beyond is financial structure and regulation. By this I mean all those legal provisions, statutory or administrative, that constitute the set of constraints within which the financial system operates and subject to which financial institutions of all sorts compete. They include the differential tax treatment of banks and thrift institutions, laws governing the issuance and exchange of corporate securities, the conditions of government insurance and guarantee of residential mortgages, and the manner in which the federal banking agencies administer the Bank Merger Act. All affect not only the efficiency of the financial system but the relative position of the various institutions in competing for their share of the "intermediation pie."

The past decade has witnessed a dramatic shift in commercial banking regulatory policy. Fading memories of the Depression; the challenge presented by such rapidly growing financial institutions as the savings and loan associations, mortgage companies, and pension funds; the aforementioned increased sophistication of corporate treasurers and their growing unwillingness to keep large amounts of idle funds; and increasing public and Congressional concern about the consolidation and merger movement in progress among commercial banks since the early 1950s---all these and other factors prompted a two-pronged and, to some degree, conflicting attack on the existing regulatory fabric.

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On one prong was the fear of excessive concentration of financial resources in the economy and the dangers it harbored for healthy competition. The results of this new concern are familiar history today. The first visible manifestation came a few years before the beginning of the Sixties, in the form of the Bank Holding Company Act of 1956. It was intended to restrain the growth of mammoth multibank holding company systems which would have possible adverse effects in the form of increased concentration and lessened competition, and which had the effect of nullifying state branching statutes. The Act introduced broad competitive and other public interest criteria for holding company acquisitions, and assigned responsibility for their administration to the Federal Reserve System.

The Bank Merger Act of 1960 was the next major step in the realignment of public policy toward competition in banking. It placed initial jurisdiction over bank mergers involving insured banks in the hands of the three federal banking agencies, the particular agency in each case depending on the charter and Federal Reserve membership status of the resulting bank, and required each agency, in considering proposed mergers to give explicit weight to the effects on competition.

The other prong of the attack on existing regulation has also taken a generally pro-competitive form. The proponents of this line of attack sought to free banks from what they deemed to be a regulatory strait-jacket inhibiting their growth and unnecessarily limiting the scope of their services. The guiding role in this attack on existing regulation was played by the Office of the Comptroller of the Currency. Between 1962 and 1965 the Office lowered the barriers to entry of new national banks and permitted national banks to offer travel, data processing, and armored car services; to underwrite revenue bonds; to

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manage commingled investment funds; and to open loan production offices anywhere in the country without regard for state branching restrictions.

On their own initiative, bankers were looking for routes that would permit them to bypass some of the restrictions surrounding banking. Some bankers believed to have found it in the one-bank holding company, which, unlike the multibank holding company, was not subject to Federal Reserve regulation. By forming a holding company to acquire the bank's own stock, and then using subsidiaries of the holding company, either newly formed or acquired, to engage in activities prohibited to the bank, they hoped to get around the severe restrictions on bank activities. By 1970, most of the major banks in the country, having in the aggregate more than half of total banking resources, had organized one-bank holding companies.

The Bank Holding Company Amendments of 1970 eliminated a key advantage of one-bank holding companies by subjecting them to the same regulatory treatment accorded multibank holding companies and delegated to the Board of Governors of the Federal Reserve System authority to determine, in accordance with broad principles laid down in the Act, which activities shall be permissible for bank holding companies. Though maintaining the separation between banking and industry and commerce, the amended Act has been interpreted to permit at least some additional latitude in the activities open to bank holding companies.

Similar trends toward broadening the permissible scope of activities have been observable in financial industries other than commercial banking. Savings and loan associations and mutual savings banks have asked for, and received, the power to make limited third party transfers from savings accounts in Massachusetts and New Hampshire. Savings and loans are seeking broader powers to make con-

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sumer loans. In 1969, a bill to enable savings and loans to convert to Federal Savings Associations with greatly broadened lending powers received serious consideration before finally being defeated. The trend toward increased diversification of individual financial institutions and a blurring of the distinctions between the different types of institutions was given a further boost by the recommendations of the Hunt Commission.

So far as projections for the next decade are concerned, there is no obvious cloud on the horizon that should cut short the further development of the trends of the 1960s. Financial institutions can be expected to become more and more alike as they each diversify further, and more and more reliance may well be placed on market forces, as opposed to arbitrary restrictions, in determining the scope and nature of their services. Before Congress at the present time are the Administration's proposals to increase the powers of thrift institutions and to eliminate interest rate ceilings on deposits. These proposals may win acceptance if some way can be found to insulate the mortgage market from the effects of cyclical fluctuations in the money markets. Looking further down the road, the decade should see some progress in liberalizing state laws governing branch and group banking.

It is doubtful, however, whether institutional jealousies and states' rights arguments can be overcome to the extent that, by the end of the decade--or even by 1990--there will be one federal agency granting all-purpose financial charters to all comers, and possessing authority to authorize branch offices anywhere in the country. Nor would that clearly be a desirable eventuality. The small, efficient unit bank has an important place in the future of American banking. But some continuation of past trends is a reasonable expectation.

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One caveat that should be expressed here is that, while the forces for liberalization of regulatory provisions in evidence over the past decade took years to marshall, though aided by extensive research efforts and the support of the authorities, the trend toward liberalization can be and has been reversed on several occasions by the events of a few months. Thus, the Comptroller's experiment with freer granting of national bank charters came to an abrupt end when Congress severely criticized the Office following a minor outbreak of bank failures in 1964. And the recent liberalization of Regulation Q was revoked after Congress became convinced that it had resulted in unfair competitive practices. These examples should make clear the fragility of the trends we are talking about. This is true not only of regulatory trends but of trends in the use of technology and the use of public policy as well.

I have been talking about a topic of enormous breadth and one whose total ramifications can not be fully comprehended by anyone in this assembly. The torrid pace at which developments in banking have been unfolding makes abundantly clear why the ultra-conservative image of bankers is beginning to melt. For myself, I view the changes before us with excitement and with a sense of challenge. If we plan ahead and are willing to accept the challenge, we will be in a position to both mold and digest in an orderly fashion what the future has to offer.

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