The Outlook for Banking

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We have been confronted recently by a number of banking and financial events that have attracted widespread attention. But today, rather than speculating about the problems of specific banks or their likely outcome, I want to take a somewhat broader view of banking developments and longer-term issues.

I'll leave the discussion of prospects for bank earnings and bank stock prices to the industry analysts and the commercial bankers. But at the same time, I want to say that I visualize that banking in the immediate future will probably continue to operate in an environment of firm monetary restraint as we keep up our battle against inflation--hopefully without the stimulus that fiscal policy could bring if we were to increase federal spending or cut taxes.

When considering the outlook for banking, we must remember that banks obviously are a major channel through which the government's economic policy is transmitted to other businesses and consumers. The constraints that may be imposed and central bank actions must occupy a prominent role in the policy decisions of individual banks, will affect the price of banking services to businesses and households, and will affect the outlook for the industry.

The current financial markets, especially as they relate to banking, are a direct reflection of the problems of reconciling sound bank growth with monetary control. Three times in the last decade we have had a confrontation between the efforts of banks to satisfy expanding customer credit demands and the efforts of the Federal Reserve to restrain aggregate credit and monetary expansion to a level consistent with potential productive capacity--maximum employment with minimum inflation. Each time, the result has been a severe liquidity squeeze. New peaks have been set in interest rates, with an uneven impact--hitting hardest those activities, such as residential construction, that rely most heavily on credit.

The banks have been very innovative during the past 15 years in developing sources for growth more or less independent of their traditional and unique role as creators and custodians of checking accounts held by the public. Instead of reacting to Federal Reserve monetary restraint by reducing liquid assets, they began to bid for loanable funds. They thus substituted increased liabilities for their bond account as a source of liquidity. This trend has developed in several stages--first, by raising rates paid on savings and time deposits within official time deposit ceilings; second, by selling huge amounts of negotiable certificates of deposit; and third, when official rate ceilings became an impediment, by resort to certain nondeposit liabilities--like Eurodollar borrowings. As a result, the ratio of demand deposits to total earning assets of all U. S. commercial banks dropped from 78 percent in 1960 to 43 percent in 1973.

What are the implications of this rather drastic restructuring of bank balance sheets? How should the regulators respond? To be sure, in times of strong pressure on the financial markets some institutions will have liquidity problems. But so long as their assets are basically sound, the commercial banks are probably in a better position to attract funds than any other group of money market participants other than the U. S. Treasury itself. The Federal Reserve's role as lender of last resort is, of course, an important stabilizing element in those markets.

I doubt if this trend will be easily reversed. It is unlikely that we will see very soon any tremendous decline in either interest rates themselves or in the money management skills of either corporate treasurers or the newly interest conscious consumer who wants to keep his checking account balance as low as possible. Competition for funds will continue. In one sense, all funds--certainly demand deposits and to some extent even capital--have to be purchased. We must heed the old warnings about borrowing short and lending long. But, again assuming that assets are sound, the most difficult regulatory decisions about bank liabilities that will affect banking in the years ahead will, in my view, have a great deal to do with the extent to which banks expand as intermediaries in the credit markets. This is the way banks channel funds from savers to borrowers, as distinct from their function, under our central bank umbrella as creators of new money. This is an issue that will be influenced by whether the banking system can do the job more efficiently than other market channels. Banks have some disadvantage as against other financial intermediaries, because of the reserves that must be held against time deposits and other liabilities. To the extent that persistent inflation requires persistent restraint over the rate of growth in money and credit it is unlikely that regulations will make it easier for banks to increase their share of the credit supply. But they are certainly trying.

The outlook for banking also must embrace the rise of bank holding companies. Most of the nation's largest banks are now part of bank holding company structures--involving almost two-thirds of all deposits in the country. These companies have been aggressive in acquiring nonbanking subsidiaries. The Federal Reserve must approve these acquisitions, and we are gradually developing rules as to what kind of activities are related to banking and thus legally permissible for holding companies to engage in. Nonbank subsidiaries of bank holding companies have some important advantages over banks since they do not have to hold reserves against their liabilities and they are not limited as to geographic location. The establishment of affiliated mortgage, finance, and leasing companies are often beneficial to the public interest through enhanced competition and availability of services.

But the rapid proliferation of nonbanking affiliates, especially through the acquisition of existing companies, already give us some pause. Will banks be weakened in attempts to shore up affiliates with higher-risk assets? Will hundreds of independent firms be gobbled up by giant holding companies--reducing competition and increasing concentration of economic power? If restrictive legislation is to be avoided, bank holding companies will be under increasing pressure to demonstrate that they are indeed supplying a superior product at a competitive price. And a still unresolved question is the boundary line between the bank and its nonbanking affiliates, and, therefore, the scope of Federal Reserve regulatory responsibility. Should the supervision of banks to insure their soundness encompass also the supervision of the parent company?

A third area that is profoundly affecting banking is the rapid development internationally. For many major U. S. banks with branches all over the world, foreign operations are responsible for more than a quarter of gross earnings. Money markets are worldwide. U. S. banks are in competition with foreign financial institutions, both in overseas locations and here at home. In this very competitive area, minute cost differentials can win or lose that business.

My discussion thus far probably brings to mind a few multi-billion dollar institutions. These banks may set trends and dominate statistics. But the thousands of other banks also have some important challenges ahead. There are vast differences in competitive positions among U. S. banks because of differences in legal requirements, relative access to various sources of funds, and the ability to operate through multiple offices. Some form of branch banking in Illinois is inevitable--and it could come as soon as 1975. The need to reduce inequities among banks, combined with increasing demands for sophisticated financial services by customers quite remote from money market centers and increased competition from nonbank financial institutions--savings and loans as well as affiliates of big correspondent banks--will tax the ingenuity of bankers, legislators, and regulators for many years ahead.