FRS
Chicago
83-5

83-5

A Series of Occasional Papers in Draft Form Prepared by Members of the Research Department for Review and Comment.

STAFF MEMORANDA

THE FUTURE OF COMMERCIAL BANKS IN THE FINANCIAL SERVICES INDUSTRY

George Kaufman, Larry R. Mote,
and Harvey Rosenblum

FEDERAL RESERVE BANK OF CHICAGO

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Future of Commercial Banks in the Financial Services Industry

by

George G. Kaufman*
Loyola University and Federal Reserve Bank of Chicago

Larry R. Mote*
Federal Reserve Bank of Chicago

Harvey Rosenblum*
Federal Reserve Bank of Chicago

A revised and expanded
version of a paper prepared for
the 64th American Assembly,
"The Future of American Financial Institutions,"
Harriman, New York, April 7 - 10, 1983.

*The views expressed in this paper are the authors' and do not necessarily represent the views of the Federal Reserve Bank of Chicago.

Sn 5/6/83

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Future of Commercial Banks in the Financial Services Industry*

INTRODUCTION

This paper is concerned with the future of commercial banking. It is legitimate to ask why this is an important subject. Most of the population could care less what happens to commercial banks--or savings and loans or stockbrokers, for that matter--as long as their deposits are safe. They view the ongoing battle over turf between these institutions much as they view an unfriendly corporate takeover--an interesting conflict having little or no significance for anyone outside the companies involved. Many, if not most of the legislative skirmishes now being fought concern parochial, intramural issues having little to do with any broader public interest. Nevertheless, we will argue that the customers of financial institutions and the general public have a major stake in the nature of the financial system that eventually will emerge from the current period of flux, if not in the specific identities of the winners and losers.

Why the Future of Banking Matters

Clearly, owners, managers, and employees of commercial banks have important and well-defined interests in the future success of their particular banks. But there is no reason why, in the longer run, even they could not make the transition to other banks or even other types of financial business. Thus, it is not the particular institutions that we call commercial banks whose future concerns us, but the terms on which the vital services now provided primarily by commercial banks are made available in the future.

*The authors wish to thank George J. Benston and Robert A. Eisenbeis for their helpful comments.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Customers stand to gain if these services are offered efficiently, on competitive terms, and at convenient locations, regardless of who provides them. They will lose if regulations evolve in such a way as to maintain arbitrary pricing restrictions and entry barriers that protect existing banks from competition, prevent banks and other institutions from taking full advantage of the most efficient organizational options, and discourage full use of available financial technology.

Why Regulation Before and Deregulation Now?

Although the commercial banking industry has been extensively regulated for the past half century, we will argue that much of the existing structure of regulation never made any sense and that some other parts of it have been rendered ineffective--and, in some cases, counterproductive--by recent developments in financial markets. One has to be very discriminating in judging individual regulations because some make much more sense than others. However, a charitable appraisal of restrictions on chartering, branching, and pricing--most, but not all of which were introduced during the early 1930s--would be that they were adopted for reasons that were misguided from the start; that they achieved their intended goals, if at all, only temporarily; and that they have resulted in a great deal of inefficiency through the years. As is discussed later, much of this inefficiency has consisted of higher prices and poorer services to consumers of financial services and the expenditure of real resources on innovations designed to escape regulation.

A few types of regulation--in particular, regulations limiting risk-taking by banks, restrictions on certain combinations of activities, and the requirement for prior approval of proposed bank mergers and bank holding company acquisitions-- are easier to justify and may even produce benefits

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

that exceed their costs. If, as many students of banking maintain, the costs of a massive collapse of the banking system, such as occurred in the 1930s, or even near-collapses clearly outweigh the cost of limiting the risks taken by banks, it makes sense to retain capital and portfolio restrictions. Insofar as it is federal deposit insurance or an effective central bank that prevents such a calamity, rather than regulation per se, the regulations might seem superfluous. However, given the failure of regulators either to close institutions as soon as net worth becomes zero or to price deposit insurance to reflect the riskiness of individual banks' portfolios, regulation is needed to offset the resulting incentive of risk-taking, with its attendant dangers to the solvency of the institution. This is not to say that all existing safety and soundness restrictions are optimally designed to achieve their purposes.

The contribution to the safety of the banking system of the separation of commercial and investment banking introduced by the Banking Act of 1933 is more problematical. To this day it has not been rigorously demonstrated whether the securities market abuses engaged in by several large money market banks during the 1920s were a major contributor to the banking debacle or merely a sideshow and whether they could be prevented by means short of divorcement. On the other hand, the benefits to be gained by repealing the restrictions have probably been exaggerated.

In the case of prior approval of mergers and acquisitions, the focus has been on preventing transactions that would substantially lessen competition, a clearly desirable end. However, it has been variously argued that the stringent criteria applied under the Bank Merger Act and the Bank Holding Company Act prevent some mergers that would enhance efficiency, that the existence of close substitutes for most bank services makes the exercise of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

monopoly power in banking a trivial consideration, and that whatever monopoly power does exist is due largely to entry restrictions. The truth and relevance of these contentions have not been clearly demonstrated. The banking agencies may reasonably relax their concern over the competitive effects of mergers and acquisitions as deregulation progresses, entry barriers are eliminated, and markets are broadened by the erosion of geographic and product restrictions. But the case for doing so at this time is probably not strong.

Whether or not the regulations affecting banking ever made much sense, what has happened to make it important that they be eased or eliminated at this particular time? The basic reason is that, until recently, many of the restrictions were essentially nonbinding. Interest rate ceilings on deposits, for example, were of little consequence during the two decades when market rates were well below the ceilings. When rates began to rise in the late 1950s and early 1960s, the ceilings were raised to allow competitive rates to be paid. They have generally been binding only for some years after the mid-1960s. It took the sharp rises in rates of the late 1960s and early 1970s to evoke the institutional innovations that have rendered the ceilings ineffectual and destroyed the protection that they once afforded some institutions.

Similarly, the restrictions on banks' portfolios and securities activities meant little so long as banks held enormous reserves of excess liquidity and were more concerned with survival than with aggressive expansion. But that has all changed as memories of the depression have gradually faded, liquidity and capital ratios have declined, and "unregulated" competitors have made inroads into activities long considered the exclusive preserve of commercial banks. These developments have served to expose

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

deficiencies of regulation that, though always there, were not as apparent in earlier years. As regulation's costs have become more evident and its benefits have proven to be ever more illusory, the movement toward deregulation has gained increasing momentum.

RECENT DEVELOPMENTS IN BANKING

For many years banks were unique among financial institutions because of their power both to issue demand deposits and to make commercial loans. Many other lenders, such as independent or captive commercial finance companies, could and did make a wide variety of commercial loans, but only banks issued demand deposits. Furthermore, banks could make a number of other types of loans such as home mortgages, consumer loans, farm loans, and loans to other financial institutions (including securities brokers and dealers). Banks competed in their lending with other depository institutions such as credit unions, savings and loan associations, and mutual savings banks, none of which could issue demand deposits, and with nondepository institutions like insurance companies, finance companies, cooperative lenders, and government and quasi-government agencies. Each of the nonbank lenders tended to specialize, primarily by law, in a single type of lending or a narrow range of lending products.

What Banks Can Do Now

The business of banking today still centers on the lending function. Banks can make loans to just about any individual, partnership, corporation, government entity, or group of individuals for virtually any purpose. The only regulatory restrictions are those of prudence; banks must limit their exposure to individual borrowers (loans to any single borrower may not exceed some legally set proportion of a bank's capital, now 15 percent for national

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

banks) and are under subtle regulatory pressure through the bank examination process to lend to credit worthy customers.

Sources of Funds--To fund the wide variety of loans that they make, banks rely on an equally wide variety of sources of funds. No longer do noninterest-bearing demand deposits constitute the dominant or even leading source of funding. In 1950, the ratio of demand deposits to assets stood at 70 percent; at year-end 1981 it had fallen to 19 percent; and it may be expected to fall even further with the growth of money market deposit accounts and super NOW accounts. Now the most important source of funding for banks is time deposits, including those available for third-party transactions purposes. As of year-end 1981 they were equal to 52 percent of assets. Within this broad category are several dissimilar instruments differing in denomination, maturity, negotiability, transactions capability, interest sensitivity, holder, and issuer. In addition to deposits, banks utilize other sources of funds. These include federal funds, repurchase agreements, commercial paper downstreamed from the parent bank holding company, capital notes, and equity. The most noticeable feature about the sources of bank funds today vs., say, 1950, is the substantially higher proportion of interest-sensitive funds--i.e., liabilities offering market-related rates of return.

This last point is worthy of additional emphasis because it marks a fundamental turning point in the underlying nature and economics of the banking business. Banks' established position as the most important and diversified lenders in the United States was fortified in the 1930s by the monopoly power created by federal deposit insurance and interest rate ceilings on deposits, which, when combined with banks' exclusive franchise to offer demand deposits, gave them advantages over their competitors. However, no

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

monopoly lasts forever, and banks' local monopolies in the provision of demand deposits were no exception. They were eroded eventually by the incentive they created for customers and potential competitors to develop substitute products, by technological developments that reduced customers' dependence on the monopolized product, and by the natural inefficiency that eventually afflicts any monopoly not subject to direct competitive pressures.

The erosion of their monopoly positions has forced banks to change. Although they still have a large clientele for loans, banks have to be more innovative in the new environment than they were and work harder to find sources to fund the loans. Wholesale banks have been faced with this reality for a long time; retail-oriented banks have only begun to face this situation in the last few years. Large money center banks were the first to make this transition because their customers were big enough both to be attractive to the nonbank competition and to raise funds on their own without going through the banks--e.g., by selling commercial paper. Demand deposits haved declined sharply in importance at all banks because of reduced transactions costs and a growing number of highly liquid (though imperfect) substitutes that can easily and cheaply be converted into commercial bank demand deposits just long enough to effectuate a transaction. As a consequence of these developments, the deposit relationships between banks and their business customers are less important now than in the past.

Diversification--In part because of increased competition and reduced margins in lending, banks began to diversify into other lines of activity. However, banks have not taken such diversification very far, at least as measured by the ratio of noninterest revenue to net interest income, which averaged about 40 percent for the 15 largest banks in 1981. However, this was still a substantial increase over the 28 percent in 1977 (see table 1).

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Because interest rate ceilings on deposits encourage bundling of services and payment for services with deposit balances, rather than explicit fees, noninterest income relative to interest income may understate the importance of nonlending output. Nevertheless, even after allowing for this factor, it is clear that intermediation between borrowers and ultimate lenders is still banks' primary activity. Diversification by banks and bank holding companies into nonlending activities is constrained by various laws and regulations to such bank-related activities as trust services, data processing, money orders and travelers checks, management consulting to depository institutions, and providing courier services, among other things. (For a complete list of permissible activities, see table 2.) The extent to which banks and bank holding companies have taken advantage of individual diversification possibilities is difficult to quantify because they are not required to report income by product line.

Citicorp's Activities--One of the most aggressive bank holding companies in entering new activities and seeking new clientele has been Citicorp. Although, as can be seen in table 3, most of its activities still center on the lending and deposit-taking functions, other activities have been a rapidly growing source of its revenue. In 1977 fees, commissions, and other revenues were equal to 23.1 percent of Citicorp's net interest revenue (interest income less interest expense); by 1981 this ratio had grown to 65.2 percent.

Recent Legal and Economic Changes

In recent years banks have begun to offer both new and old services over greatly expanded geographic areas. They have accomplished this expansion by taking advantage of "loopholes" in the existing legal structure. Much of this structure was outmoded by changes that have taken place in technology and in the level of interest rates relative to the interest rate structure that had

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

been in effect at the time the statutes, regulations, and interpretations were written.

Product Market Expansion--Banks, either themselves or through their holding companies, have entered a number of new product lines in recent years. Among the new product lines entered since 1975 are management consulting for unaffiliated banks, retail sales of money orders, real estate appraisal, issuance of small-denomination debt instruments, and check verification. These (and other activities) are noted in footnote 1 of table 2. Recently, the Federal Reserve Board added four new activities: 1) acting as a futures commission merchant, 2) performing an expanded range of data processing services, 3) purchasing a financially troubled savings and loan association, and 4) discount brokerage (an activity previously approved by the Comptroller of the Currency for national banks and by the FDIC for nonmember insured banks). Except for the expanded data processing services, which have now been incorporated into Regulation Y, each of these was permitted by order to particular individual institutions rather than by regulation to all institutions. With the passage of the Garn-St Germain Depository Institutions Act of 1982 (DIA), the Congress sanctioned bank holding company acquisitions of weak or failing S&Ls when alternatives are scarce. The DIA also allowed banks to offer deposits competitive with money market funds, an activity some larger banks had been attempting to enter in numerous innovative ways, only to run into a regulatory stone wall.

Geographical Expansion--On the surface, the barriers to geographic expansion in banking seem to be quite severe, particularly in comparison with the freedom enjoyed by nondepository financial institutions and nonfinancial firms. Nevertheless, Citicorp, according to its 1981 Annual Report, had 2,265 offices worldwide. In the United States alone it operated 848 offices in 40 states and the District of Columbia. Yet, roughly half the banks in the United States operated either a single office or one head office and at most

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

two or three additional limited facilities, usually within a mile or two of the main office. This paradox results from the interaction of several types of legal restrictions: 1) state laws that limit the freedom of state-chartered banks to expand geographically; 2) the McFadden Act of 1927, as amended by the Banking Act of 1933, which subjects national banks to the branching laws of the states in which they are domiciled; 3) the Douglas amendment to the Bank Holding Company Act, which prevents bank holding companies from acquiring out-of-state banks except with the express authorization of state law; and 4) the absence of geographic restrictions on nonbank subsidiaries of bank holding companies. A bank in Illinois, for example, can establish one branch within a mile of its head office and another within two miles. Until as recently as 1967, Illinois banks were only allowed the head office. Yet, Illinois bank holding companies can--and do--establish nonbank offices throughout the country. Numerous other states such as Texas, Nebraska, and Oklahoma also have unit banking laws. In these states a large number of independently chartered banks are needed to meet the population's banking needs. Thus, in 1980 Illinois had 1,286 banks for a population of 11.4 million, but only 16.0 banking offices per 100,000 population. By contrast, California, which allows statewide branching, had only 283 banks to meet the banking needs of 23.7 million people in 1980; however, these banks operated 4,563 banking offices (including head offices), or 19.3 offices per 100,000 population.

The really binding rules with respect to geographic expansion have to do primarily with deposit-taking; a bank cannot establish an out-of-state office for the purpose of accepting deposits. A bank can, however, accept and solicit out-of-state deposits from offices within its home state, either through brokers or by placing ads in out-of-state newspapers and other media, and banks do so at both the wholesale and retail level. As the technology of transferring funds has improved and as transactions costs have been reduced by

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

improvements in the means for disseminating information, the importance of out-of-state offices for generating deposits has greatly declined. As table 4 indicates, the generation of certain kinds of deposits has become a nationwide phenomenon. Large denomination, or wholesale, sources of funds such as federal funds and large negotiable CDs have long been purchased in national money markets. More recently, banks have been able to sell fully insured deposits in smaller denominations through offices of brokerage firms throughout the country.

Bank lending is much less restricted geographically. Banks may establish loan production offices wherever they please, and most larger banks have taken advantage of this leeway to service loan customers concentrated in particular geographic areas. Loans can be solicited anywhere; it is merely the location of the office that issues the loan that may be restricted.

Because nonbank subsidiaries of bank holding companies do not accept deposits, they are afforded more geographic freedom than bank subsidiaries. Permissible nonbank activities may be carried on anywhere in the United States unless restricted by state law. Many of the nation's larger banks have achieved a near nationwide geographic presence by expanding into permissible nonbank activities like consumer finance, mortgage banking, and numerous other lending and nonlending activities under Section 4(c)(8) of the Bank Holding Company Act. Table 5 shows the geographic dispersion of some of the larger bank holding companies.

Geographic restrictions are sometimes greater in the bank's home state or home country than in foreign countries. First Chicago Corporation has more branches in foreign countries than in the United States. Unit banking laws are only part of the reason; although Citicorp's 1,417 offices in 93 foreign countries far outnumber its 848 domestic offices, Citibank itself does have 318 bank branches in the state of New York, a number that exceeds its 248 branches and representative offices in foreign countries.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In general, the only current limitations on geographic expansion, other than the establishment of full-service deposit gathering offices, seem to be a banker's imagination, capital resources, and perception of profitable opportunities.

Causes of Change

Why have pressures for regulatory change suddenly appeared in recent years? The primary reason is that the existing structure of regulation was no longer effective. As documented above, such dramatic changes had occurred that the reality bore little resemblance to the legal structure. But this did not happen overnight. Signs of the growing ineffectiveness of regulation had been noticeable for many years. A number of banking reform commissions had been established, starting with the Commission on Money and Credit in 1958, to examine the reasons for the deterioration and to make recommendations for changes to improve the effectiveness of the laws governing the financial system. (The work and recommendations of these commissions are reviewed in Jacobs and Phillips, 1983.) But the recommendations were, for the most part, left lying on the table (Jones, 1979). Until the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982, only piecemeal changes had been made. These changes served to delay more serious deterioration but did not make the fundamental changes that could have prevented the decay.

Much of the existing regulatory structure was put in place in response to the crisis of the 1930s. Bank safety and the preservation of the country's financial system were the overriding considerations. Economic efficiency, equitable treatment of customers, and other desirable objectives were put on the back burner. New regulations reduced competition through restricting entry, limiting branch banking, and curtailing interest rates paid on

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

deposits. They also reduced risk exposure through eliminating the need to seek higher yielding, riskier loans to finance high deposit rates and by restricting the types of activities in which banks could engage. These regulations were grafted onto a structure of specialized financial institutions which were kept out of each others' turf partly by their own conservatism but primarily by the high costs of transferring, processing, and storing funds and information.

But few things in life stay fixed, and the economic and technical environments began to change shortly after World War II. In the 1960s, the changes in these environments accelerated and provided both the economic incentive and the technical means to circumvent existing regulations. The acceleration of the rate of inflation in the mid-1960s caused market rates of interest to climb above the ceiling rates commercial banks and other depository institutions were permitted to pay on deposits, bringing about disintermediation on a broad scale. Further acceleration of inflation in the 1970s pushed market rates on some loans, particularly to households and smaller business firms, above usury ceilings in many states.

Immediate raising or removal of the ceilings on deposit rates has not always been viewed as desirable by policy makers, as some institutions, particularly thrifts, were locked in to low, fixed-rate mortgages that they had made in earlier periods of slower inflation, and payment of the higher deposit rates would have been a serious drain on their resources. Moreover, policy makers tended to be overly optimistic that inflation would slow in the near future and viewed the ceilings as temporary expedients until interest rates declined again. Thus, depositors searched for alternative securities that had characteristics similar to deposits but paid market rates of return while thrift institutions searched for new powers that would protect them from similar experiences in the future.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The development of the electronic computer provided the means by which financial institutions were able to offer deposit-like services that made it easy and cheap to bypass deposit rate ceilings on time deposits and the prohibition of interest payments on demand deposits. This culminated with the introduction by existing depository institutions of interest-bearing transactions balances in the form of negotiable order of withdrawal (NOW) accounts and the introduction of money market mutual funds by new, "unregulated" competitors. The popularity of these accounts led those institutions hurt most by deposit losses to bring intense pressure on legislators and regulators either to liberalize the regulations or to extend them to competitors. The major successes of the deregulation movement so far have been the Depository Institutions Deregulation and Monetary Control Act of 1980, which enlarged thrift institutions' asset powers and will phase out deposit interest rate ceilings by 1986, and the Garn-St Germain Depository Institutions Act of 1982, which authorized money market deposit accounts effective December 1982. Subsequently, the Depository Institutions Deregulation Committee authorized super-NOW accounts effective January 1983. The interest rates on balances over $2,500 in either of these accounts are not regulated. The new technology also permitted the development of new products such as generic cash management accounts that bundle into one package a number of services previously marketed separately, including interest-bearing accounts, check-writing privileges, credit cards, lines of credit against predetermined collateral, and security trading, combined with complete on-line and hard copy accounting statements of all transactions.

Although it is too early to say for sure, the new electronic technology may reduce further the apparently small economies of scale in banking (Benston, Hanweck, and Humphrey, 1982), thereby enhancing the ability of smaller institutions to compete and survive. This tentative conclusion

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

contradicts the frequently heard assertion that small institutions will not survive in the age of the computer because of the great economies of scale and utilization associated with electronic processing of transactions. However, the conventional argument confuses economies of scale in data processing with economies of scale in the financial services firm. To the extent that data processing services can be purchased from a service bureau--and small banks not only do this but, in some cases, have organized jointly owned service companies to provide such services--the economies are external to the financial services industry itself and need not imply economies of scale for firms within that industry. Such economies could, of course, result in some degree of concentration in the computer services industry. But the ultimate outcome in banking depends on future developments both in technology and in the organizational arrangements by which financial institutions obtain data processing services.

HOW BANKS HAVE FARED IN RECENT YEARS

Problems of Measurement

In assessing how well banks have fared in recent years relative to their competitors, one encounters several problems of measurement. One of these is of an organizational nature. In comparing banking with nonbanking competitors, should only the bank's activities be considered or, when the bank belongs to a holding company, those of the entire organization? There would appear to be a strong case for including the activities of all the subsidiaries of the holding company in such comparisons. Clearly, the performance of the holding company, not the bank, is the ultimate concern of stockholders and managers. More importantly for our purposes, the competitive effects of market share and concentration are best measured by combining the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

shares of all institutions under common control, rather than by looking only at the share accounted for by some selected group of subsidiaries.

Another problem concerns the choice of the unit of measurement. A common choice, has been assets, largely because data have usually been available. However, a total assets measure would greatly understate the importance of a brokerage and investment banking firm like Merrill Lynch relative to the banking industry, making the country's largest broker appear smaller than many medium-sized banks. This is because the primary roles of such a firm are those of broker, underwriter, and dealer, with inventories of securities largely limited to those maintained for trading purposes. Thus, the assets of such a firm would in no way reflect the scope and extent of its financial activities--at least until it got into the business of operating money market mutual funds. On the other hand, a total assets measure inflates the economic contribution of money market mutual funds, since the service offered by such funds is primarily to add an additional layer of intermediation between investor-depositors and banks, thereby enabling smaller investors to overcome the impediments to higher returns imposed by interest rate regulation and reserve requirements.

A possible alternative measure that would avoid these problems is employment, which is not subject to the same distorting effects as total assets and, presumably, is closely related to the firm's economic contribution. However, employment is an input, and its use begs the important question of whether institutions differ in their productivity and/or relative use of labor and capital in generating output. Moreover, employment is itself a function of banking structure, varying directly with the number of banking offices and inversely with the degree to which banks are free to compete on price. A related measure that in some degree accounts for

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

differences in the quality and productivity of employees is employee compensation. Other measures, such as profits and value added, are superior on conceptual grounds, but accurate data on them are simply not available.

Banks' Share of the Financial Services Market

There is a widespread impression that banks have continually lost market share to other financial and nonfinancial firms in recent years. However, after a sharp loss in market share in the years following World War II, banks seem to have held their own since 1960. Data from the Flow of Funds accounts (table 6) indicate that, although bank holding companies have gained market share in some product lines and lost share in others, their share of total financial intermediation as measured by assets has varied between 36.5 percent and 39.5 percent in the 1960-81 period. The employment and employee compensation data in table 7 also provide evidence of the continued strength of banks' position in the financial services sector.

Inroads by Other Financial and Nonfinancial Firms

The stability of banks' overall market share since 1960 contradicts the perceptions of many bankers that nonbank financial and nonfinancial firms were steadily encroaching on commercial banking's traditional product lines. In large part, that perception was based on the fact that such firms have, indeed, made major inroads in specific financial services. It was also engraved in bankers' consciousness by a 1974 study by Cleveland Christophe (published by Citicorp) titled Competition in Financial Services, which documented the extent of unregulated firms' activities in the extension of consumer credit. Christophe's findings were startling to many bankers, as few had recognized the importance of the competition represented by firms such as Sears and General Electric whose primary activities were nonfinancial. Most bankers were aware of competition from consumer finance companies and

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

depository institutions, but the fact that Sears had more active charge accounts and volume (as of 1972) than either Master Charge or BankAmericard (the predecessors of MasterCard and Visa) was somewhat disquieting to many in the banking industry.

Indeed, Sears and its two large national retailer rivals, Montgomery Ward and J.C. Penney, had combined installment credit ($6.9 billion) exceeding that outstanding at the nation's three largest bank holding companies (BankAmerica, Citicorp, and Chase Manhattan with $4.3 billion) by more than 50 percent. If that weren't bad enough, Sears earned more money after taxes in 1972 on its financial service business than did any bank or bank holding company in the country. That Sears had such a large volume of consumer receivables--its $4.3 billion of credit card receivables at year-end 1972 was roughly 80 percent of the $5.3 billion of installment credit on all bank credit cards--should not have been surprising. Sears began to provide consumer credit to support its retail operations in 1910.

However, table 8 shows that by 1981 bank cards had displaced Sears from its preeminent position in the credit card business. Visa is the current leader in charge volume, a very important measure of business activity because the income generated from merchants' discount fees is proportional to charge volume. With domestic charge volume of $29.3 billion in 1981, Visa nearly tripled the volume of Sears; in 1972, Sears' volume was 73 percent greater than Visa's. Visa is also the leader in number of active accounts and customer balances. Moreover, MasterCard is only slightly smaller than Visa. Many retailers have begun accepting one or both bank cards alongside their own proprietary cards. For example, J.C. Penney began accepting Visa in 1980 and MasterCard in 1981. Montgomery Ward now accepts both bank cards.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

To analyze the extent to which other changes occurred over the past decade, Harvey Rosenblum and Diane Siegel updated and expanded the Christophe study and compared the bank-like activities of about 40 financial and nonfinancial companies with those offered by the largest bank holding companies (Rosenblum and Siegel, 1983). As can be seen in table 9, the trends cited by Christophe nearly a decade ago continued unabated through 1981, as most of the industrial and retailing giants identified in his study expanded their financial services further. In 1981, as shown in table 10, seventeen companies had profits from financial activities that exceeded $200 million. Of these, nine are bank holding companies; the other eight are Prudential, American Express, Aetna, Equitable, ITT, Sears, General Motors, and Merrill Lynch. Furthermore, finance companies are no longer strictly "captives". Five top companies, as shown in table 11, have evolved in a way that allows them to conduct less than 10 percent (and as little as 1 percent) of their financing in conjunction with the sale of their parents' products.

Table 12 lists 27 of the largest lenders in the United States (each with over $5 billion in receivables). Of the top 10 companies shown, seven are bank holding companies, one is an insurance company and broker, and two are the finance subsidiaries of automobile manufacturers. Of the other 17 companies, only eight are bank holding companies.

Perhaps the best way to examine the effects on banks of nonbank entry is to look at what has happened in individual product lines. Turning first to consumer finance, we find that the largest bank holding companies have made impressive gains in the last decade vis-à-vis certain of their nonbank competitors. This is shown in figure 1.

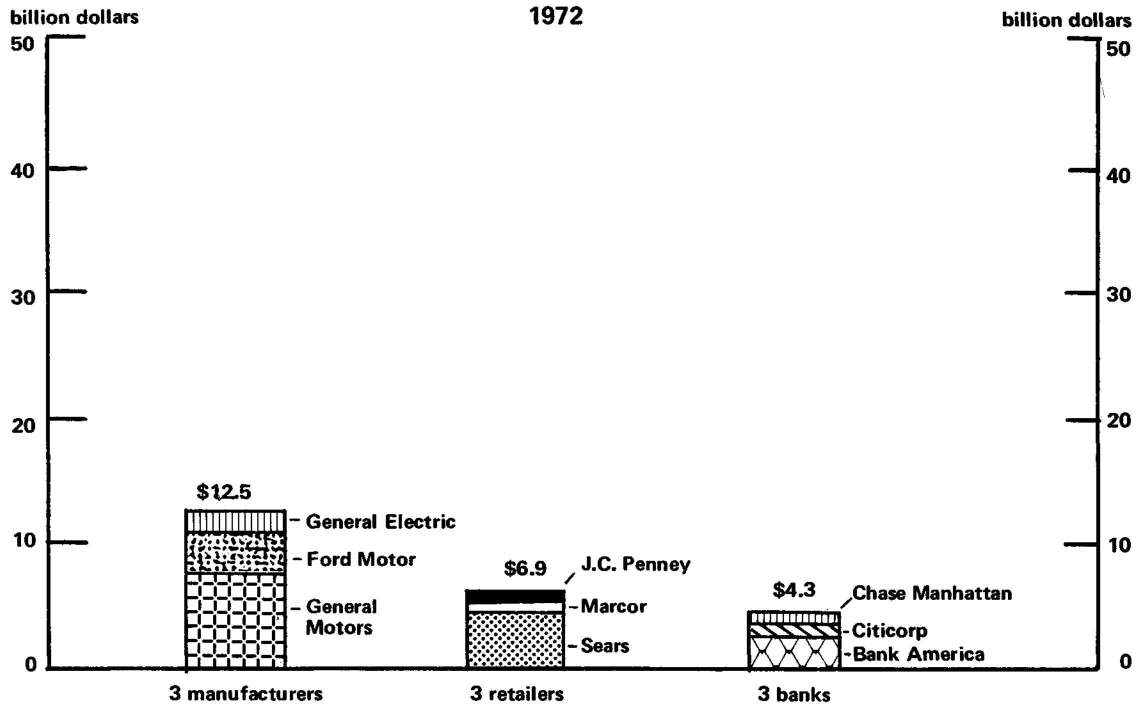
As indicated by table 13, auto lending is dominated by commercial banks, which held 47 percent of the market at year-end 1981. But the three captive automobile financing subsidiaries held 33 percent of the market.

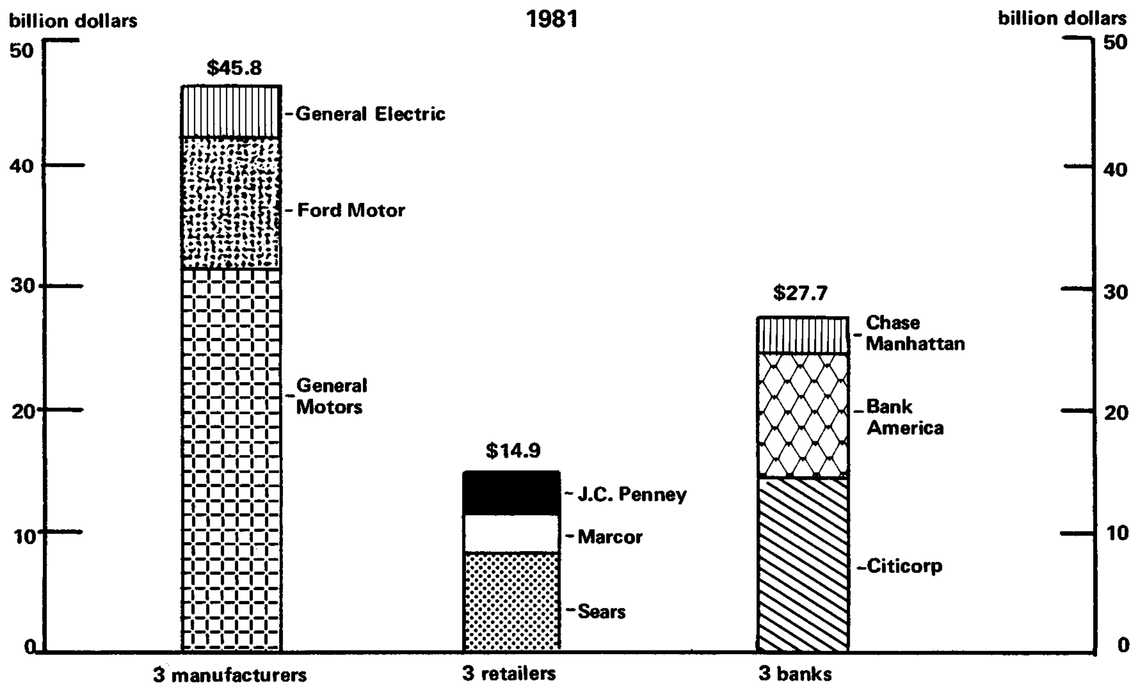
LIBRARY
FEDERAL RESERVE BANK OF DALLAS

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Figure 1

WORLDWIDE CONSUMER INSTALLMENT CREDIT HELD BY SELECT LARGE BANK HOLDING COMPANIES, RETAILERS, AND CONSUMER DURABLE GOODS MANUFACTURERS AT YEAR-END





SOURCE: Rosenblum and Siegel, Chart 1.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Furthermore, the banks' share was 13 percentage points below the peak reached only three years earlier in 1978. Over the same period, the share of the captive finance companies increased by 12 percentage points.

Banks still account for the lion's share of outstanding commercial and industrial (C&I) loans in the United States. As is shown in table 14, the 15 largest bank holding companies held $141.6 billion of domestic C&I loans at year-end 1981, almost triple the total held by the selected 34 nonbank companies studied by Rosenblum and Siegel. Nevertheless, the importance of the nonbank lenders should not be underestimated. There is growing evidence that, for smaller businesses, trade credit is the most widely used source of credit, both in terms of the percentage of firms utilizing it and in dollar volume. Trade credit is an imperfect substitute for bank credit because it cannot be used to pay other creditors or meet employee payrolls. Nevertheless, its importance cannot be ignored. Moreover, many of those firms that supply trade credit have alternatives to short-term bank credit. At year-end 1981, nonfinancial firms had $77.4 billion of commercial paper outstanding. Some portion of this was used to provide credit to other businesses.

Foreign banks have also added to competition in business lending during the last decade. At year-end 1981, U.S. branches and agencies of foreign banks held $31.1 billion of C&I loans to U.S.-domiciled businesses. This is equal to about 10 percent of the amount of C&I loans issued by U.S. banks to U.S. businesses.

With respect to commercial mortgages, banks are an important source of funds, but less so than insurance companies. Four of the insurance companies that have made forays into bank-like services--Prudential, Equitable, Aetna

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Life & Casualty, and American General--had $35.5 billion of commercial mortgages outstanding at year-end 1981; this compares with $24.5 billion of worldwide commercial mortgages held by the 15 largest bank holding companies. If a greater number of insurance companies had been included, the insurance sector would have appeared more dominant in this lending area.

Nor do commercial banks dominate in lease financing. The $16.9 billion of lease receivables of the 34 nonbank companies studied by Rosenblum and Siegel exceeded the total lease receivables of all commercial banks combined.

Of these 34 nonbanking firms, 10 operated money market funds (see table 15). These 10 companies accounted for nearly 40 percent of all money market fund assets in December 1982. If money market fund shares are directly competitive with commercial bank deposits, then those 10 companies combined rank about halfway between the Bank of America and Citibank, the nation's two largest banks. Merrill Lynch, with money market fund assets of $50.4 billion as of December 1, 1982, was roughly comparable in size with Manufacturers Hanover Bank, which had worldwide deposits of $42.5 billion at year-end 1981. Among the 10 companies listed in table 15, only Sears and Ford were among the companies studied by Christophe a decade ago.

Despite losing market share in a number of product lines--e.g., automobile lending and the provision of liquid savings instruments--banks have outstripped their rivals in a number of other areas, most dramatically in credit cards. On balance, their gains have roughly offset their losses, leaving their aggregate share of the financial services market unchanged, as the aggregate figures suggested. In order to judge how well banks have done in the more fundamental sense of their basic financial strength and their probable ability to compete in the future, it will be necessary to look beyond market share to profitability and riskiness.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Bank Profitability

William Ford, President of the Federal Reserve Bank of Atlanta, recently startled bankers by arguing that the primary reason so many financial and nonfinancial institutions were encroaching on the traditional turf of commercial banks was that banking has been very profitable (Ford, 1982). In a market characterized by no barriers to entry, entry occurs where the grass is the greenest. And the evidence appears to support Ford. Banking has been highly profitable through the post-World War II period and has become even more profitable in recent years. As is shown in table 16, net after-tax accounting income of insured commercial banks steadily increased from about 0.60 percent of assets in the 1950s to almost 0.90 percent in the early 1970s before sliding down to near 0.75 percent in the last half of the decade. As a percent of either total capital or only equity capital, bank net income increased through most of this period and reached record levels in recent years. The return on equity was 50 percent greater for banks than the average for all financial and nonfinancial firms, as calculated from IRS data. However, it was slightly less than for some individual nonfinancial industries, such as motor vehicles. Bank return on assets was consistently lower than for nonfinancial firms, but this reflects primarily differences in leverage ratios and in accounting practices, since assets are not stated at market values and stated net income does not directly reflect changes in the market value of net worth.

In contrast, the accounting earnings of mutual savings banks and savings and loan associations deteriorated sharply from 1960 through 1980. Indeed, considering that the bulk of the thrifts' assets (mortgages) are overstated as a consequence of unexpected increases in interest rates, their earnings during this period are overstated. Thus, their true profitability relative to commercial banks is even worse than the figures indicate.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

As noted, accounting data have severe limitations, which are compounded by the fact that assets are of different importance in different industries and book values differ from market values by different amounts in different industries. Thus, the book value of assets or of capital makes a poor base against which to measure profitability. The failure to treat market value equally in all industries also distorts the income data. These problems are generally not present if profitability is measured by the total return to stockholders' investments, as valued in the stock market. But data on returns on commercial bank shares are only fragmentary at this time and require further refinement before they can be used meaningfully. Further, data are available only for the largest banks and bank holding companies, as the shares of smaller banks are not actively traded.

As documented in an earlier section, commercial banks have expanded into a variety of nonbanking financial activities through bank holding companies. How well have they done? Based on the fragmentary evidence available, they have not done too well. Two studies have found that mortgage banks affiliated with bank holding companies have not only been less profitable than independent mortgage banking firms, but have grown more slowly (Talley, 1976 and Rhoades, 1975). Studies have also found that bank-affiliated finance companies were less profitable than unaffiliated companies but did grow faster (Talley, 1976 and Rhoades and Boczar, 1977). Lastly, equipment leasing firms affiliated with banks were considerably less profitable and considerably riskier than their unaffiliated counterparts (Rhoades, 1980).

Nevertheless, after allowing for the less-than-resounding success of bank holding companies in these activities, their overall profitability still appears to have been impressive. But profitability is only one side of the coin in evaluating the performance of an industry. The other is risk.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Riskiness

It is often argued that bank failures have greater adverse impact on the economy than the failures of most other firms, in particular when they accumulate. The original justification for many of today's regulations was that they would reduce the risk of widespread bank failures. Thus, the present and potential risk exposure of banks is of importance for formulating both private and public policy towards banking.

Risk, though, is even more difficult to measure than profitability. For a firm, risk is often considered as the probability that losses will exceed capital, forcing the firm into bankruptcy. Under certain assumptions regarding the probability distribution of returns, this probability can be measured by the volatility or variability of earnings. The more volatile are earnings, the greater is the probability that the cumulative losses may exceed the amount of capital. The standard deviations of banks' annual returns on assets and on total equity between 1960 and 1980 were 0.1 percent and 1.43 percent, respectively. In contrast, the standard deviations for these two measures for mutual savings banks were 0.14 percent and 2.33 percent and for savings and loans associations 0.17 percent and 1.12 percent, and they are considerably greater for the nonfinancial sectors examined. Measured on a return per unit of risk basis, commercial banking was by far the most profitable industry relative to assets and was only slightly less profitable relative to equity than the average for all firms.

Because of the shortcomings of accounting data, some analysts prefer to measure profitability by stock market returns. Risk is then measured either as the overall volatility in returns or as the volatility of the stock market as a whole. The latter risk measure is said to reflect "systematic" risk or the riskiness of a given stock or portfolio relative to the risk inherent in the stock market and is quantified by the "Beta"(β) coefficient. A β equal to

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

1 for an individual stock or a portfolio of stocks indicates that it is just as risky as the market; a β greater than 1 indicates above-average risk; and a β of less than 1, below-average risk. The average β for a sample of large bank holding companies over the last 15 years has been close to .90, suggesting that commercial bank holding companies have been slightly less risky than the average firm whose shares are traded on major stock exchanges. In more recent years, β for those holding companies has increased somewhat, possibly suggesting that banking has become more risky as a consequence of deregulation.

Commercial banks, like other firms, are able to control the risks they incur to some degree by managing their asset and liability portfolios. For banks, the two major risks assumed are interest rate risk and default risk.

Interest Rate Risk

Interest rate risk occurs because the interest paid on deposits does not always change by the same amount and at the same time as the interest received on loans and investments. If the average maturity of deposits is shorter than the average maturity of assets, an unexpected sharp increase in market interest rates causes the interest paid on deposits to exceed that earned on assets; thus, the bank experiences losses. The bank can influence its losses or gains from unexpected interest rate changes by changing the average interest rate sensitivity of its deposits relative to its assets. Rate-sensitive securities are securities whose coupon or contract interest rates change in parallel with changes in market rates of interest. Moreover, by matching the average interest sensitivity of its assets perfectly with that of its liabilities, a bank can eliminate interest rate risk, as all interest rate shocks are passed through from deposits to assets on a one-to-one basis.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Recent studies suggest that, unlike thrift institutions, commercial banks have balanced the interest rate sensitivity of the securities on the two sides of their balance sheets reasonably well and have incurred little interest rate risk (Flannery, 1980a and 1980b). However, some individual banks--for example, the First Pennsylvania Bank, N.A. in 1980--have deliberately mismatched the interest sensitivity of the two sides, often with poor results.

Default Risk

Traditionally, the risk with which bankers have been most concerned has been default risk. For purposes of analysis, actual defaults may be divided into two types--non-crisis defaults and crisis defaults. Non-crisis defaults are defaults that occur randomly at any stage of the national business cycle. Crisis defaults are defaults that are triggered by downturns in national economic activity that reduce the ability of a large number of firms to service their debt fully. The risk of non-crisis defaults may be controlled by the individual institution through diversification and the establishment of adequate loss reserves. To the extent that crisis defaults are more difficult to predict and the losses very large, the risk of their occurrence is much less under the control of the individual bank. But crisis and non-crisis defaults are limiting cases; most defaults are a blend of the two. As the economy weakens, more and more marginal borrowers experience lower than expected revenues and find it more difficult to make timely payments on their debt. Thus, defaults are likely to be clustered.

Default risk is priced by the market as the difference between the expected returns on a security and a comparable default-free security. This difference represents the market's best estimate of the expected loss from default. The available evidence indicates that, at least for marketable securities, actual losses do not differ greatly from default risk premiums over long periods of time (Hickman, 1958 and Atkinson, 1967). It is thus

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

necessary that these premiums be recognized by the lenders as reserves to cover future losses and not as earnings. The recent experiences of some major banks with energy loans and loans to less developed countries suggest that, prior to these developments, the banks failed to accord appropriate accounting recognition to this risk.

As is well known, firms may reduce their overall risk by entering, either de novo or through acquisition, new activities that have earnings streams either negatively correlated with or independent of their own. This has been one motivation for the use of bank holding companies to expand into nonbanking types of activities. Three recent studies have examined the evidence on the success of this strategy. The first study (Boyd, Hanweck, and Pithyachariyakul, 1980) examined the impact of bank holding company expansion on the probability of bankruptcy when bank holding companies expanded into nonbanking activities during 1971 through 1977. It concluded that the

> results to date suggest that the potential for risk reduction via nonbank diversification is, at best, limited. The probability of bankruptcy is minimized by very small investments in each nonbank line of business. In fact, the industry has already exceeded the risk-minimizing level of investment in 11 of 19 lines of business. However, the industry has not yet expanded sufficiently into any nonbank area so as to materially increase bankruptcy risk. (p. 113)

Indeed, because the variance of returns is much higher in many nonbanking activities than in banking, bank holding company expansion into some permissible activities could significantly increase the likelihood of bankruptcy. These activities include investing in community welfare, credit cards, investment advising, and trust services. Bank investments in these lines, however, are currently well below the levels that would threaten solvency. For most bank holding companies, commercial banking is by far the most important activity, accounting on average for 97 percent of their assets in 1977.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A later study (Stover, 1982) using similar methodology reported that these results understated the potential risk reductions because the earlier study considered only activities which were permissible to bank holding companies at the time and in which they actually participated. This study also analyzes the implications of diversification into both permissible activities (not all of which the holding companies actually participated in) and nonpermissible financial activities. The study concluded that risk could be significantly reduced and performance significantly increased by entering some of these activities. In particular, Stover identified casualty insurance, investment banking, and savings and loan associations. The last activity was included primarily because its earnings were negatively correlated with those of commercial banking. In light of recent events, the value of the negative correlation would have been offset by the negative earnings of savings and loan associations.

This finding is indirectly supported by another study that examines the stock performance of banks after they formed bank holding companies (Eisenbeis, Harris and Lakonishok, 1982). It finds that, in the late 1960s when large banks formed one-bank holding companies, their stock prices increased, on the day that the formations were announced, by more than would have been predicted on the basis of past relationships. This phenomenon suggests that investors believed that the new organizations would be more profitable, less risky, or both. Announcements of holding company formations after 1970 were not accompanied by unpredicted jumps in stock prices. The authors attribute this to the Bank Holding Company Act Amendments of 1970, which subjects one-bank holding companies to the same restrictions on activities as multibank companies, thereby limiting the possible diversification and risk reduction. However, a similar study by Aharony and Swary (1981) failed to find any such change between the pre- and post-1970 periods.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

PROBABLE FUTURE DEVELOPMENTS

What banks have done in the past and how well they are doing now has been amply documented. But what does the future hold? What role will commercial banks play? In part, this will be determined by legislation and regulation, but it will largely depend on the banks themselves and, in particular, the decisions they make over the next several years.

Goals and Strategic Planning

In a deregulated environment, banks will have to decide which services to emphasize, which customers to pursue, and how best to meet the competition of others. No longer will their product lines and geographical market areas be determined for them by the government. They will have to survey the market, identify potential opportunities, specify their goals, and determine how best to achieve them. This process is what is meant by strategic planning. In a world of choices, planning becomes an increasingly important function. Deregulation increases the risks and the work load.

Banks may want to examine the market structure of the investment banking industry, their perceived major rival. The structure of this mostly unregulated industry resembles that of the grocery store industry: a few large supermarkets operating retail and wholesale offices nationally, a few large wholesale firms operating nationally out of a limited number of offices in major cities, a greater number of regional supermarkets and specialty retail firms, and numerous local specialty firms. The industry even has its counterpart of the "7-11" stores and "warehouse," bare-shelf markets. Edward Jones, a regional firm out of St. Louis, operates 377 basically one-person shops. This is the second largest number of offices of any firm in the industry, even though Jones ranks only 102nd in capital and 27th in number of employees. Bare-shelf, no-advice discount brokers developed after the deregulation of commission rates in 1975. As would be expected from the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

industry's dynamism of recent years, most investment banking firms are profitable. While there is an ongoing consolidation of larger firms, primarily as a result of continuing deregulation, there has been substantial entry by smaller firms.

In a recent study (Bleeke and Goodrich, 1981), McKinsey and Company examined the characteristics of industries that underwent deregulation. Among the effects observed were increased variability in profits, severe price pressures, unbundling of products, introduction of new products, cost-cutting, and increased need for capital. In large measure this was brought about by the entry of new low-cost specialized producers, who aimed at particular segments of the market previously overlooked, and by mergers among existing firms, particularly the absorption of weaker firms that had not prepared for the changeover. The study concluded that the winning firms fell into three broad categories: 1) national, full-line firms; 2) low cost producers; and 3) specialty firms. Each group followed different and distinct marketing strategies. This study suggests that planning is particularly important for firms in industries undergoing deregulation. They have to learn how to operate under different ground rules.

The importance of adapting to different rules may be seen by noting that brick and mortar branches were a necessity under Regulation Q to compete for consumer deposits, but they are less necessary under a free market where competition is largely on the basis of price. In addition, deregulation tends to reduce bank employment because more personnel are required to compete when service competition is the only kind allowed. The recent acceleration in deregulation caught many banks and, in particular, thrift institutions with excessive numbers of branch offices. Planning might have prevented at least some of this overinvestment, which will be costly for some years to come. Unlike gifts, branches cannot be readily disposed of when conditions change.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Commercial banks can ease the process of deregulation and succeed in the new environment by taking advantage of all the flexibility and options that are now available to them. On the lending side, for example, many banks have shaken off their product and geographic shackles by using the bank holding company device. Deregulation of deposit interest rate ceilings will likely improve the penetration by nationally oriented bank holding companies into the markets of self-chosen, locally limited banks.

In the last year or so competition for deposits has taken some new forms. Alliances that would have been termed "unholy" not long ago are commonplace now. Merrill Lynch, the same company that has $50.4 billion of money market fund assets that purportedly compete with bank and thrift deposits, acts as a broker in the placement of retail CDs issued by many banks and thrifts, thus giving them a nationwide reach. Nor, as can be seen in table 4, is Merrill Lynch alone in this regard; it is joined by many other investment banking firms, including Sears/Dean Witter, Shearson/American Express, and E. F. Hutton. Together, these four companies operate about 1,325 offices nationwide. Collaboration with national brokerage houses enables comparatively small institutions such as City Federal Savings and Loan of Elizabeth, New Jersey, to compete toe-to-toe with Bank of America for retail CDs.

The market for funds in denominations greater than $1 million has been national ever since Citibank invented the negotiable certificate of deposit in 1961. The same is true of the market for large repurchase agreements. Bank-related commercial paper, also sold in a national market, amounted to some $31.9 billion at year-end 1981. What was true a decade ago for wholesale deposit markets is now becoming true at the retail level--the geographic scope

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of retail deposit markets is broadening. Some banks have begun to compete for retail deposits nationally, particularly since deposit interest rate ceilings have been eliminated on most time and savings deposits, and these accounts are fully insured so that the identity of the bank is not of great interest to most depositors using brokers. Another example of the expanding geographic reach of banks in deposit gathering is provided by Citibank (South Dakota) which has taken several advertisements in the Wall Street Journal that invite the reader to contact a Citibank account representative about rates and other terms offered on Citibank consumer CDs. Contact is available via a free 800 telephone number. Ironically, one of the Citibank advertisements recently appeared right next to a similar ad from a money market fund.

Bankers' Complaints: Justified or Gratuitous?

In recent years, commercial banks have increasingly complained about the inroads other financial and nonfinancial firms have made into their traditional banking turf and about regulations that hamstring them from counterattacking and invading their opponents' home turf. This attitude is reflected vividly in a recent booklet entitled The Old Bank Robbers' Guide to Where the New Money Is published by Citibank. The booklet counsels Willie Sutton, the well-known bank robber of yesteryear who guaranteed his immortality by explaining that he robbed banks because "that's where the money is," to:

> try the brokerage houses that run the money market funds. But that's not all. Try the insurance companies, the retailers, bus lines, manufacturers, travel agents, movie makers, utilities, data processors, publishers and anyone else who's gone into the financial services business. That's where the money is! (Citibank, p. 3).

The extent of the inroads of nonbanks into commercial banking has already been documented in the previous section.

Are the commercial banks justified in their complaints? Are they constrained by regulatory, legal, or other external barriers from offering the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

same services as their new-found competitors? We shall examine the ability of banks to offer each of the 18 services cited in the Citibank booklet and listed in table 17, only the first five of which Citibank acknowledged banks could offer.

Perhaps the service offered by nonbank competitors that bankers have complained about most is the generic cash management account (CMA). This account usually combines five separate services, all of which are included on Citibank's list--a consumer credit line, a credit card, security trading, a money market account, and check writing--wrapped together by a single accounting statement. It was first introduced by Merrill Lynch in 1977, but did not take off immediately. Indeed, for some years it was viewed as a "dog", generating much paperwork, but little income for brokers (Smith, 1982).

Commercial banks were always able to offer consumer credit lines and credit cards, to trade and take positions in federal government and most municipal government securities, and to serve as agents for the remaining municipal and all corporate security transactions. However, only recently did banks attempt to expand their activities in the corporate security area. Early in 1983, BankAmerica Corporation received permission from the Board of Governors of the Federal Reserve System under the Bank Holding Company Act to acquire all the shares of Charles Schwab & Company, the nation's largest discount broker. A year earlier, the Security Pacific National Bank entered into a cooperative arrangement with Fidelity Brokerage to provide brokerage services to its customers on a fee basis and also received permission from the Comptroller of the Currency to operate a discount brokerage service as a subsidiary of the bank. Although commercial banks are prohibited by the Glass-Steagall Act of 1933 from giving investment advice and taking positions

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

in some municipal revenue and all corporate securities--that is, from being full-service investment bankers--as agents they can directly execute trading orders on all securities generally included in cash management accounts. In contrast, savings and loan associations may invest in full-service investment banking firms.

Paying market rates of interest on deposits has been a more severe problem for the commercial banks when market interest rates climbed above Regulation Q ceilings. Selling money market funds not subject to interest rate ceilings has been considered a sale of securities and therefore not permissible under the Glass-Steagall Act. However, it is clear that the problem is due to Regulation Q, not to the Glass-Steagall Act, insofar as it prevents banks from offering small investors a deposit account paying market interest rates. Yet, until recently, few banks, other than the largest, actively lobbied for the repeal of Regulation Q. In addition, banks could have provided customers with repurchase agreements. Although these are not insured, neither are money market fund accounts.

Check writing facilities are not a problem, of course. Indeed, money market funds use commercial banks for this service. It would have been technically possible for banks to tie check writing with repurchase agreements through some form of overdraft provision. Although such arrangements were likely to have encountered resistance from the Federal Reserve, the important point is that they were not tried. If they had been combined with earlier lobbying against Regulation Q, changes might have occurred before December 1982. But even earlier, a number of banks had designed cash management services.

Continuing down the list, commercial banks always were able to extend loans and mortgages. Thus, any losses of market share in these services could

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

not be blamed totally on regulation. As discussed earlier, historically, banks were Johnnies-come-lately in both services.

The other services on the list are either not flourishing or not strictly financial and have not been the target of major inroads. Life, property, and casualty insurance have not been exceptionally profitable in recent years, although insurance brokerage probably would complement nicely the activities of larger banks. Real estate trading may complement mortgage banking, but is not strictly financial. Nor are travel agencies and car rentals. This is also true of data processing and telecommunications, which banks can do for themselves and, on a limited basis, for others.

Thus, with the possible exception of full-line securities activities, it would appear that commercial banks have been inhibited in their expansion into other financial services in recent years as much by internal, self-imposed constraints as by external constraints. They were simply out-imagined and out-competed. Because banking has been relatively profitable during these years, bank management may not have felt the drive to seek additional profits in new, uncharted waters. Belatedly, commercial banks have begun to realize this and have taken the first steps to break their internal cultural bonds and do battle with the invaders.

PUBLIC POLICY CONCERNS

As far as regulatory reform has already gone, and despite the effective nullification of some restrictions by the workings of the marketplace, further legal and regulatory changes are necessary if the goal of an optimal financial structure is to be achieved. To the extent that it is deemed desirable for banks and other financial institutions to offer broader ranges of services or compete in broader geographic markets, they should not be forced to resort to clumsy organizational expedients to do so.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Geographical Restrictions

Among the most obviously outdated and undesirable restrictions remaining are geographical limitations on holding company and branch bank expansion, including home office protection. Although geographic expansion through nonbank subsidiaries of bank holding companies, loan production offices, banking by mail, and toll free phone numbers has negated some of the barriers to competition erected by state branching laws, protected pockets of privilege still prevail in some local markets, particularly in deposit-taking and small business lending. There are no obvious economic reasons why even these isolated sanctuaries from competition should be allowed to survive.

Branch banking has been severely restricted in most states, for reasons ranging from fear of monopoly to outright protectionism designed to maintain the small bank as a local institution. The latter reason for restricting branching has often been buttressed by the argument that branch banks have not been convincingly demonstrated to be superior to unit banks in terms of operating efficiency--although a recent study (Weisbrod, 1980) indicates that, when account is taken of the benefits to consumers of the greater convenience offered by branching, branch banks do much better in comparison with unit banks. In any event, this argument is irrelevant. Enlightened public policy does not consist in outlawing all those forms of business enterprise which have not been shown unquestionably to be efficient, but in allowing all forms to compete for the consumer's favor in a free marketplace.

The states' rights arguments against a federal override of existing state branching restrictions, at least for national banks, are similarly misguided. The fact is that there appears to be little popular opposition to branch banking. In practice, the branching issue has been decided in most states by the small bank lobby. More importantly, the arbitrary restrictions placed on banking by state branching laws should no more be tolerated than state taxes

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

designed to eliminate chain stores or the sale of yellow-colored margarine. All are impediments to commerce imposed for the benefit of competitors, not competition.

On the other hand, in phasing out these geographical restrictions, certain safeguards would seem desirable. The frequent proposal to move first to reciprocal interstate branching on a regional basis is not as innocuous as it may seem. In fact, it would enable existing institutions within each region to merge, increasing local concentration and reducing the opportunity for heightened competition that would result if each such institution acquired, or were acquired by, a banking organization headquartered in another region of the country.

Mergers and Acquisitions

Similarly, though some liberalization of merger and acquisition policy might be a natural and desirable result of eliminating geographic restrictions, care should be taken to prevent anticompetitive acquisitions. Existing antitrust laws may be adequate to the task, but greater assurance might be achieved through new legislation. One option that might be considered would be an upper limit on the number of offices a banking organization could operate in any local market, perhaps taking account of area and population. While allowing banks to expand essentially wherever they wished, such a provision would prevent concentration in local banking markets and impose an upper limit on concentration nationwide.

The arguments for eliminating existing restrictions on product offerings of various institutions are similar, although some of the side issues are quite different. A continuation of the trend in the Depository Institutions Deregulation and Monetary Control Act and the Garn-St Germain Depository Institutions Act would eventually result in a financial system consisting of firms with all-purpose charters and no price constraints in which

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

specialization would simply be the result of a business decision, rather than of law or regulation. In such an environment, a congressional decision to subsidize housing would be an above-board choice to override the marketplace, rather than to grant special benefits to a specialized financial institution. The result, one may surmise, would not be a reduced level of subsidization of housing but a more efficient subsidy.

Among the few serious issues that might reasonably be invoked to block the complete abolition of functional restrictions is the fear of conflicts of interest. Despite assurances that such conflicts could easily be policed, and despite the skepticism regarding conflicts of interest by some academic economists, this fear remains strong and little concrete evidence has been adduced to assuage it. Consequently, the Glass-Steagall restrictions on security underwriting and dealer activities by banks may be among the last to go--if, in fact, they do go. In this context, it is also of some importance to remember that the Glass-Steagall restrictions on bank securities activities are not barriers to entry in the usual sense, but barriers to entry by only one type of institution representing only 15,000 of the more than 70,000 financial services firms and the nearly 3 million nonfinancial firms in the country.

THE FUTURE

The future of the banking industry will be exciting, both for the public and, in particular, for the industry itself. More changes are likely to occur in the next five years than in the last 50 in terms of both products and structure. Deregulation has displaced the structure from its previous equilibrium. There will be considerable and at times rather wild churning until a new equilibrium is reached. As the old ground rules disappear, uncertainty will increase. Conditions may appear chaotic for a period, particularly to outsiders. In such a situation, not everyone will react the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the same way or as effectively. Thus, there will be winners and losers before everyone settles down to the new ground rules. Market shares will change, and, either through absorption or through liquidation, the losers will depart from the industry. There will even be some new entrants. How many firms will survive when the churning stops is anyone's guess. What is obvious is that there will be fewer than the 15,000 commercial banks, 4,000 savings and loan associations, 500 mutual savings banks, 20,000 credit unions, 2,000 life insurance companies, 250 money market funds, 500 other mutual funds, 3,000 property liability insurance firms, 3,000 security dealers, 3,000 finance companies, 800 mortgage bankers, and many more self-managed pension funds and other financial institutions than we have now.

Although the departure of a goodly number of firms will produce a considerable uproar about the plight of the industry, it should be of no more concern to the public than the failures of a number of brokerage firms after the demise of fixed commissions in 1975 or, more recently, the actual and threatened departures of some older firms in the airline industry. (Actually, there are almost twice as many airlines today as there were before deregulation, albeit many are small and specialized.) The institutions that we call commercial banks today are likely to be heavily represented among the survivors, but that result is by no means guaranteed, nor is it a matter of great concern from society's standpoint. As we argued at the beginning of this paper, the public is interested in the quality and price of the services offered, not in the identity or health of any particular suppliers.

The surviving institutions will need to respond to a new set of circumstances. This will not be easy to do and the penalties for being wrong will be much more severe than before. Moreover, firms will be paying dearly for past responses that were correct under the old ground rules but are now

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

incorrect. As noted earlier, the construction of additional branches was the correct strategy for gathering consumer and small business deposits as long as all competitors were limited to paying the same interest rates. But with the freeing of deposit rates, competition by price is likely to dominate competition by convenience and many of the branches will become costly white elephants.

Because of the increasing importance of technology, the new entrants are likely to be firms outside the financial services industry such as computer software and hardware firms. Smaller firms that find it costly to develop their own delivery systems will be able to rent them either from suppliers outside the industry or from larger firms within the industry, possibly on a franchise basis. Competition will be intense. But for the survivors and the public at large the future looks bright.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 1

Noninterest Income as a Percent of Net Interest Income

	1977	1978	1979	1980	1981
	(- - - - - - - - - - -	- - - - -	percent	- - - - -	- - - - - - - - - - - -)
Citicorp	23.1	32.8	32.2	46.0	65.0
BankAmerica Corp.	24.0	22.6	25.0	32.0	35.0
Chase Manhattan Corp.	33.1	30.2	28.6	35.0	37.0
Manufacturers Hanover Corp.	23.3	23.1	22.8	26.5	41.4
Continental Illinois Corp.	31.5	32.9	36.2	33.4	40.0
Chemical New York Corp.	23.0	25.0	23.1	24.9	32.8
J. P. Morgan & Co.	44.1	53.1	47.4	55.4	64.6
First Interstate Bancorp	21.3	17.7	17.7	19.8	25.0
Security Pacific Corp.	33.1	30.0	32.9	41.4	44.7
Bankers Trust New York Corp.	36.2	22.3	38.0	49.7	50.0
First Chicago Corp.	37.1	43.0	46.7	64.6	57.5
Wells Fargo & Co.	19.3	16.9	16.1	24.1	32.3
Crocker National Corp.	17.9	15.0	16.1	19.1	23.9
Marine Midland Banks, Inc.	21.6	18.5	20.5	22.0	27.3
Mellon National Corp.	24.5	25.9	26.0	31.6	31.9

SOURCE: Company Annual Reports and 10-K forms.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 2

Permissible Nonbank Activities for Bank Holding Companies Under Section 4(c)8 of Regulation Y, April 1983

Activities permitted by regulation

1. Extensions of credit[2]
   Mortgage banking
   Finance companies: consumer, sales, and commercial
   Credit cards
   Factoring
2. Industrial bank, Morris Plan bank, industrial loan company
3. Servicing loans and other extensions of credit[2]
4. Trust company[2]
5. Investment or financial advising[2]
6. Full-payout leasing of personal or real property[2]
7. Equity or debt investments in community welfare projects[2]
8. Providing bookkeeping or data processing services to holding company subsidiaries and, with restrictions, to others[2]
9. Acting as insurance agent or broker primarily in connection with credit extensions[2]
10. Underwriting credit life, accident, and health insurance directly related to extensions of credit by the holding company system
11. Providing courier services[2]
12. Management consulting for unaffiliated banks[1,2]
13. Sale at retail of money orders with a face value of not more than $1000 and U.S. Savings Bonds and issuance and sale of travelers checks[1,2]
14. Performing appraisals of real estate[1]
15. Management consulting to nonbank depository institutions

Activities permitted by order

1. Buying and selling gold and silver bullion and silver coin[2,4]
2. Issuing money orders and general-purpose variable denominated payment instruments[1,2,4]
3. Futures commission merchant to cover gold and silver bullion and coins[1,2]
4. Underwriting certain federal, state, and municipal securities[1,2]
5. Check verification[1,2,4]
6. Financial advice to consumers[1,2]
7. Issuance of small denomination debt instruments[1]
8. Futures commission merchant[1]
9. Discount brokerage[1]
10. Arranging equity financing[1]
11. Purchasing a financially troubled savings and loan association[1,5]

Activities denied by the Board

1. Insurance premium funding (combined sales of mutual funds and insurance)
2. Underwriting life insurance not related to credit extension
3. Real estate brokerage[2]
4. Land development
5. Real estate syndication
6. General management consulting
7. Property management
8. Computer output microfilm services
9. Underwriting mortgage guaranty insurance[3]
10. Operating a travel agency[1,2]
11. Underwriting property and casualty insurance[1]
12. Underwriting home loan life mortgage insurance[1]
13. Orbanco: Investment note issue with transactional characteristics

---

[1]Added to list since January 1, 1975.
[2]Activities permissible to national banks.
[3]Board Orders found these activities closely related to banking but denied proposed acquisitions as part of its "go slow" policy.
[4]To be decided on a case-by-case basis.
[5]Operating a sound thrift institution has been permitted by order in Rhode Island and New Hampshire only.
[6]Subsequently permitted by regulation.
SOURCE: *Economic Review* (Federal Reserve Bank of Atlanta, September 1982), p. 17, as updated by the authors.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 3

The Global Activities of Citicorp in 1981

A. In U.S.A. (40 state and District of Columbia)

Subsidiary	Function	Branches/Offices
Citibank	Commercial banking	284 branches, NYC area
Citibank (NY State)	Commercial banking	34 branches, upstate NY
Citicorp (USA)	Corporate lending	17 offices in 14 states
Citicorp Industrial Credit	Equipment finance, leasing, factoring, commercial finance	32 offices in 22 states
Citibank International	Edge Act international banking corporation	13 branches in 10 states
Citicorp Real Estate	Commercial mortgages, project finance	13 offices in 10 states
Citicorp Capital Investors	Venture capital—debt/equity finance	New York, San Francisco, London
Citibank (South Dakota)	Mastercard/Visa national operations; commercial banking	Sioux Falls, SD
Carte Blanche	Travel and entertainment card	Cardholders nationwide
Diners Club	Travel and entertainment card	Cardholders nationwide
Citicorp Services	Traveler's checks	Agents worldwide
Citicorp Person-to-Person	Home equity and personal finance	153 offices in 36 states
Citicorp Acceptance Company	Manufactured housing/ auto/recreational-vehicle finance	50 offices in 30 states
Retail Consumer Services	Private-label charge-card services	18 offices in 12 states
Citicorp Associates	Processing and related services for depository institutions	58 offices in 18 states

B. Overseas (92 countries and territories)

Subsidiary	Function	Branches/Offices
Citibank	Commercial banking	Branches of Citibank and its banking subsidiaries in 75 countries; representative offices in 11 additional countries*
Citicorp International Group	Merchant (investment) banking	Subsidiaries, representative offices, and affiliates in 15 countries
Citibank Overseas Investment Corp.	Holding company	Subsidiaries and affiliates in 36 countries, including overseas operations of Carte Blanche and Diners Club

*Citibank is represented in six further countries by commercial banks in which it has substantial minority interests.

SOURCE: Citicorp, by permission.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 4

Depository Institution-Broker Relationships in the Distribution of Insured Retail Deposits As of August 1982

MERRILL LYNCH (475 offices)
ALL-SAVERS CERTIFICATES for 15 thrifts nationwide
RETAIL CDs* for 20 banks and thrifts nationwide including Bank of America
SECONDARY MARKET IN RETAIL CDs of 2 banks and 2 thrifts
91-DAY NEGOTIABLE CDs for Great Western Federal Savings and Loan, Beverly Hills

DEAN WITTER (8 Sears stores with financial center pilot programs and 320 Dean Witter offices nationwide)
RETAIL CDs* for 2 thrifts including Allstate Federal Savings and Loan
SECONDARY MARKET IN RETAIL CDs for City Federal Savings and Loan, New Jersey

BACHE (200 offices in 32 states)
ALL-SAVERS CERTIFICATES for City Federal Savings and Loan
RETAIL CDs* for City Federal Savings and Loan and one S&L in Los Angeles

SHEARSON/AMERICAN EXPRESS (330 domestic offices)
ALL-SAVERS CERTIFICATES for Boston Safe-Deposit & Trust Company
RETAIL CDs* for selected banks and thrifts

FIDELITY MANAGEMENT GROUP (29 offices in 50 states)
ALL-SAVERS CERTIFICATES for 6 banks including Security Pacific National Bank and First National Bank of Chicago

E.F. HUTTON (300 offices in 50 states)
ALL-SAVERS CERTIFICATES for 15 regional banking companies

EDWARD D. JONES & COMPANY (435 offices in 33 states)
ALL-SAVERS CERTIFICATES for Merchants Trust Company, St. Louis

MANLEY, BENNETT, McDONALD & COMPANY (10 offices in 2 states)
ALL-SAVERS CERTIFICATES for First Federal Savings & Loan, Detroit

PAINE WEBBER (240 offices)
ALL-SAVERS CERTIFICATES for 2 banks in California, including Bank of America

CHARLES SCHWAB & CO. (offices in 38 states)
ALL-SAVERS CERTIFICATES for First Nationwide Savings and Loan, San Francisco

THE VANGUARD GROUP (offices in 50 states)
ALL-SAVERS CERTIFICATES for Bradford Trust Company, Boston

---

*3½-, 4-, 5-year, and zero coupon certificates of deposit.

SOURCE: Various issues of *American Banker* and other general business periodicals, as given in Rosenblum and Siegel, Table 14.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 5

Geographic Locations of the 15 Largest Bank Holding Companies: 1981

Bank Holding Companies		Offices	
	States	Nonbanking	Banking*
Citicorp	40 & D.C.	422	25
BankAmerica Corp.	40 & D.C.	360	38
Chase Manhattan Corp.	15 & D.C.	42	4
Manufacturers Hanover Corp.	32	471	28
Continental Illinois Corp.	14	20	28
Chemical New York Corp.	23	135	6
J.P. Morgan & Co.	6	7	5
First Interstate Bancorp	13	19	24
Security Pacific Corp.	39	427	7
Bankers Trust New York Corp.	4	2	8
First Chicago Corp.	27	23	14
Wells Fargo & Co.	16	52	6
Crocker National Corp.	6	15	5
Marine Midland Banks, Inc.	5	14	not available
Mellon National Corp.	13 & D.C.	151	11

*These figures are exclusive of banking branches in their home states but include offices of bank subsidiaries.

SOURCE: Annual Reports and 10-K forms, as given in Rosenblum and Siegel, Table 15.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 6

Total Private Financial Assets, 1945-1981

	1945	1950	1955	1960	1965	1970	1975	1976	1977	1978	1979	1980	1981
							(billion dollars)						
Commercial Banking	143.8	147.8	185.1	228.3	340.7	504.9	834.3	905.5	1002.9	1146.8	1274.5	1386.3	1520.7
(U.S. Banks)				224.2	335.0	448.9	786.0	845.4	936.3	1056.0	1161.4	1244.7	1352.2
(Domestic Affiliates)						3.0	12.8	18.8	18.9	20.6	25.2	29.5	37.5
Savings and Loan Associations	8.7	16.9	37.7	71.5	129.6	176.2	338.2	391.9	459.2	523.6	579.3	629.8	663.8
Mutual Savings Banks	17.0	22.4	31.3	41.0	59.1	79.3	121.1	134.8	147.3	158.2	163.3	171.5	175.3
Credit Unions	.4	.9	2.4	6.3	11.0	18.0	31.1	43.3	51.6	58.4	61.9	69.2	75.2
Life Insurance Companies	43.9	62.6	87.9	115.8	154.2	200.9	279.7	311.1	339.8	378.3	420.4	469.8	508.8
Private Pension Funds	2.8	6.7	18.3	38.1	73.6	110.4	146.8	171.9	178.3	198.3	222.0	286.8	293.2
State and Local Government Employee Retirement Funds	2.7	5.0	10.7	19.7	34.1	60.3	104.8	120.4	132.5	153.9	169.7	198.1	221.7
Other Insurance Companies	6.9	12.6	21.0	26.2	36.5	49.9	77.3	93.9	113.2	133.9	154.9	180.1	184.2
Finance Companies	4.3	9.3	17.1	27.6	44.7	64.0	99.1	111.2	133.8	157.5	184.5	198.6	224.9
Real Estate Investment Trusts						3.9	14.0	9.8	7.2	6.8	6.7	5.8	5.5
Open-End Investment Companies (Mutual Funds)	1.3	3.3	7.8	17.0	35.2	46.8	43.0	46.5	45.5	46.1	51.8	63.7	64.0
Money Market Mutual Funds							3.7	3.7	3.9	10.8	45.2	74.4	181.9
Security Brokers and Dealers	4.9	4.0	5.9	6.7	10.3	16.2	18.5	26.8	27.7	28.0	28.2	33.5	41.8
TOTAL	236.7	291.5	425.2	598.2	929.0	1330.8	2111.6	2370.8	2642.9	3000.6	3362.4	3767.6	4161.0
							(percent of total)						
Commercial Banking	60.8%	50.7%	43.5%	38.2%	36.7%	37.9%	39.5%	38.2%	37.9%	38.2%	37.9%	36.8%	36.5%
(U.S. Banks)				37.5	36.1	36.7	37.2	35.7	35.4	35.2	34.5	33.0	32.5
(Domestic Affiliates)						.2	.6	.8	.7	.7	.7	.8	.9
Savings and Loan Associations	3.7	5.8	8.9	12.0	14.0	13.2	16.0	16.5	17.4	17.4	17.2	16.7	16.0
Mutual Savings Banks	7.2	7.7	7.4	6.9	6.4	6.0	5.7	5.7	5.6	5.3	4.9	4.6	4.2
Credit Unions	.2	.3	.6	1.1	1.2	1.4	1.5	1.8	2.0	1.9	1.8	1.8	1.8
Life Insurance Companies	18.5	21.5	20.7	19.4	16.6	15.1	13.2	13.1	12.9	12.6	12.5	12.5	12.2
Private Pension Funds	1.2	2.3	4.3	6.4	7.9	8.3	7.0	7.3	6.7	6.6	6.6	7.6	7.1
State and Local Government Employee Retirement Funds	1.1	1.7	2.5	3.3	3.7	4.5	5.0	5.1	5.0	5.1	5.0	5.3	5.3
Other Insurance Companies	2.9	4.3	4.9	4.4	3.9	3.7	3.7	4.0	4.3	4.5	4.6	4.8	4.4
Finance Companies	1.8	3.2	4.0	4.6	4.8	4.8	4.7	4.7	5.1	5.2	5.5	5.3	5.4
Real Estate Investment Trusts						.3	.7	.4	.3	.2	.2	.2	.1
Open-End Investment Companies (Mutual Funds)	.5	1.1	1.8	2.8	3.8	3.5	2.0	2.0	1.7	1.5	1.5	1.7	1.5
Money Market Mutual Funds							.2	.2	.1	.4	1.3	2.0	4.4
Security Brokers and Dealers	2.1	1.4	1.4	1.1	1.1	1.2	.9	1.1	1.0	.9	.8	.9	1.0
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	99.9%
Trade Credit by Nonfin. Firms (billion dollars)	20.6	44.4	67.6	81.4	119.5	189.1	249.6	268.4	299.5	357.5	427.6	460.8	496.0
% of Total TPFA	8.7	15.2	15.9	13.6	12.9	14.2	11.8	11.3	11.3	11.9	12.7	12.2	11.9
% of Commercial Banks	14.3	30.0	36.5	35.7	35.0	37.4	29.9	29.6	29.9	31.2	33.6	33.2	32.6

SOURCE: Board of Governors of the Federal Reserve System, *Flow of Funds.*

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 7

Banking's Percentage of Financial Sector[1]

	1950	1960	1970	1979
Full-time employees	32.8	31.8	35.4	37.2
Employee compensation	32.3	31.3	33.2	33.2
Net income[2]	n.a.	35.1	26.6	19.7
Value added	n.a.	32.9	31.0	28.5

[1]Banks include commercial banks and mutual savings banks.

[2]Net income of banks as a percentage of financial sector net income is a volatile series. The first year of data is 1957 when banks accounted for 23.7 percent; in 1958 banks' share jumped to 37.5 percent, only to drop to 23.9 percent in 1959 before recovering to 35.1 percent in 1960. Over the 1957-79 period, this net income ratio ranged from a low of 14.4 percent (in 1968) to a high of 37.5 percent (in 1958), with a median of 20.3 percent.

SOURCE: Employee data are from *The National Income & Product Accounts of the United States 1929-76: Statistical Tables* (United States Department of Commerce, Bureau of Economic Analysis), p. 256 and *Survey of Current Business: Revised Estimates of National Income and Product Accounts* (United States Department of Commerce, Bureau of Economic Analysis, July 1982), p. 241; net income data are from various issues of *Statistics of Income: Corporation Income Tax Returns* (Department of the Treasury, Internal Revenue Service); value added data are derived from all of the above sources.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 8

Consumer Credit Card Programs of Major Card Issuers

	1972	1981
Number of Active Accounts at Year-End (millions)		
Sears	18.5	24.5
MasterCard	10.3	22.1
Visa	10.0	25.8
American Express	—	10.0
Customer Charge Volume ($ billions)		
Sears	6.3	9.8
MasterCard	5.9	26.1
Visa	4.4	29.3
American Express	—	n.a.
Total Customer Account Balances at Year-End ($ billions)		
Sears	4.3	6.8
MasterCard	2.8	12.3
Visa	2.3	15.2
American Express	—	4.2

SOURCE: Data for 1972 are from Christophe, Chart II, p. 6 and data for 1981 are from company Annual Reports supplemented by phone discussions, as given in Rosenblum and Siegel, Table 9. For 1981, MasterCard and Visa data are U.S.-only, while Sears and American Express data are worldwide.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 9

Estimated Financial Service Earnings of Nonfinancial-Based Companies

	1962		1972		1981	
	Million dollars	Percent of total earnings	Million dollars	Percent of total earnings	Million dollars	Percent of total earnings
Borg-Warner	$0.5	1.5%	$6.3	10.6%	$31	18.0%
Control Data	nil	nil	55.6	96.2	50	29.2
Ford Motor	0.4	nil	44.1	5.1	186	n.a.[1]
General Electric	8.7	3.3	41.1	7.8	142	8.6
General Motors	40.9	2.8	96.4	4.5	365	109.6[2]
Gulf & Western	nil	nil	29.3	42.1	71	24.5
ITT	1.2	2.9	160.2	33.6	387	57.2
Marcor	nil	nil	9.0	12.4	110	n.a.[3]
Sears[4]	50.4	21.6	209.0	34.0	385[5]	51.1
Westinghouse	0.9	2.0	15.2	7.6	34	7.8
	103.0		662.2		1,732	

[1]Ford Motor Company had a net loss of $1,060 million in 1981.

[2]General Motors and consolidated subsidiaries had a loss of $15 million after taxes; however, after adding $348 million of equity in earnings of such nonconsolidated subsidiaries as GMAC, General Motors had after-tax net income of $333 million.

[3]Marcor has been acquired by Mobil Oil Company. In 1981, Marcor's operating loss was $160 million.

[4]Sears' financial service earnings are stated before allocation of corporate expenses to its business groups. In 1981, such expenses were $103 million.

[5]Does not include net incomes of Dean Witter and Coldwell Banker because they were acquired on December 31, 1981.

SOURCE: 1962 and 1972 data from Christophe (1974), Table III, p. 10; 1981 data from company Annual Reports and 10-K forms, as given in Rosenblum and Siegel, Table 1.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 10

Earnings from Financial Activities, 1981: Manufacturers, Retailers, Diversified Finance Companies, Insurance-Based Companies, and Bank Holding Companies

Company	Earnings ($ millions)
Prudential	1,576
Equitable Life Assurance	651
Citicorp	531
American Express	518
Aetna Life & Casualty	462
BankAmerica Corp.	445
Chase Manhattan Corp.	412
ITT	387
Sears	385[1]
J. P. Morgan & Co.	375
General Motors	365
Continental Illinois Corp.	255
Manufacturers Hanover Corp.	252
First Interstate Bancorp	236
Chemical New York Corp.	215
Security Pacific Corp.	206
Merrill Lynch	203

[1]Sears' financial service earnings are stated before allocation of corporate expenses to its business groups. In 1981, such expenses were $103 million.

SOURCE: Company Annual Reports and 10-K forms, as given in Rosenblum and Siegel, Table 2.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 11

Percent of Financing in Conjunction with Sales of Parent's Products

Company	1972	1981
General Electric Credit Corp.	9	5
Borg-Warner Acceptance Corp.	not available	9
Westinghouse Credit Corp.	43[a]	less than 1
Associates/G&W	2[b]	1
Commercial Credit/Control Data	8[b]	11

[a]Estimated from information in Christophe (1974), pp. 48-49. As of 1973, Westinghouse stated in its 10-K that the percentage of its parent's products financed was a "small portion" of WCC's business.

[b]Data shown are for 1975, the earliest date available.

SOURCE: For 1972, Christophe (1974), except as noted. For 1981, Annual Reports and 10-K forms, as given in Rosenblum and Siegel, Table 3.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 12

Total Domestic Finance Receivables of 27 Selected Companies Having Over $5 Billion in Receivables: 1981

Company	Receivables *($ billions)*
BankAmerica Corp.	52.0
General Motors	45.1
Citicorp	40.6
Continental Illinois Corp.	23.7
Manufacturers Hanover Corp.	23.1
Prudential/Bache/PruCapital	23.0
First Interstate Bancorp	21.3
Chase Manhattan Corp.	21.2
Chemical New York Corp.	20.3
Ford Motor	19.5
Security Pacific Corp.	19.2
Wells Fargo & Co.	16.1
First Chicago Corp.	14.5
Sears	13.8
Equitable Life Assurance	13.7
Bankers Trust New York Corp.	13.0
J. P. Morgan & Co.	12.9
Crocker National Corp.	12.7
General Electric	12.3
Aetna Life & Casualty	10.8
American Express	9.5
Mellon National Corp.	8.1
Marine Midland Banks, Inc.	7.9
Gulf & Western	5.9
National Steel	5.9
Merrill Lynch	5.1
Walter Heller	5.1

SOURCE: Company Annual Reports and 10-K forms, as given in Rosenblum and Siegel, Table 4.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 13

Domestic Automobile Loans Outstanding as of year-end: 1977-1981

	1981	1980	1979	1978	1977
	(- - - - - - - - - -	- - - - - - - - - -	$ millions	- - - - - - - - - -	- - - - - - - - - -)
General Motors Acceptance Corp.[1]	$ 28,545	$ 20,298	$ 17,526	$ 13,519	$10,999
Percent of total	23%	17%	15%	13%	13%
Ford Motor Credit Co.[2]	$ 10,450	$ 8,977	$ 7,678	$ 6,527	$ 5,127
Percent of total	8%	8%	7%	6%	6%
Chrysler Financial Corp.[3]	$ 1,948	$ 1,742	$ 1,472	$ 1,728	$ 1,634
Percent of total	2%	2%	1%	2%	2%
Total of three auto finance companies	$ 40,943	$ 31,017	$ 26,676	$ 21,774	$17,760
Percent of total	32%	27%	23%	21%	21%
Commercial banks	$ 59,181	$ 61,536	$ 67,367	$ 60,510	$49,577
Percent of total	47%	53%	58%	60%	60%
Other	$ 26,307	$ 24,285	$ 22,319	$ 19,363	$15,574
Percent of total	21%	20%	19%	19%	19%
Total auto loans outstanding	$126,431	$116,838	$116,362	$101,647	$82,911

[1]Includes small amount of financing of other General Motors products such as trucks and tractors.

[2]These domestic numbers are estimates. They also include a small amount of financing of Ford's other products.

[3]Includes Canadian and Mexican automotive receivables. The 1977 figure includes a small amount of European receivables as well.

SOURCE: *Federal Reserve Bulletin*, company Annual Reports and 10-K forms, as given in Rosenblum and Siegel, Table 6.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 14

Business Lending by Selected Nonbanking-Based Firms and Bank Holding Companies at Year-End 1981[a]

	Commercial and Industrial Loans	Commercial Mortgage Loans	Lease Financing	Total Business Lending
	(- - - - - - - -	- - - - - - $million	- - - - - - - -	- - - - - -)
15 Industrial/Communications/ Transport[d]	39,365	1,768	14,417[b]	55,550
10 Diversified Financial[d]	3,602	3,054	1,581[b]	8,237
4 Insurance-Based	399	35,506	892[b]	36,797
3 Retail-Based	606	—	—	606
	43,972	40,328	16,890[b]	101,190
15 Largest BHCs				
Domestic	141,582	19,481	14,279[b]	175,342
International	118,021	5,046	—	123,067
Total, Top-15 BHCs	259,603	24,527	14,279	298,409
Domestic Offices, All Insured Commercial Banks	327,101	120,333[c]	13,168	460,602

---

[a]This table includes business lending data for 32 of the 34 companies covered in Appendix A of Rosenblum and Siegel (1983). Omitted are two oil-based companies which had no commercial loan receivables at year-end 1981.

[b]Includes domestic and foreign lending and may include leasing to household or government entities.

[c]Includes all real estate loans except those secured by residential property.

[d]Financing by banking and savings and loan subsidiaries has been subtracted.

SOURCE: Company Annual Reports and 10-K forms and *Federal Reserve Bulletin*, April 1982, p. A76, as given in Rosenblum and Siegel, Table 10.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 15

Money Market Fund (MMF) Assets of Selected Nonbank Institutions: December 1, 1982

Company	Number of MMFs	Net MMF Assets
		($ billion)
Merrill Lynch	7	50.4
Shearson/American Express	10	15.5
Sears/Dean Witter	6	11.9
E. F. Hutton	3	7.7
Prudential/Bache	3	4.3
American General Corp.	2	0.4
Transamerica Corp.	1	0.3
Equitable Life Assurance	1	0.4
Aetna Life & Casualty	2	0.03
Ford Motor	1	not available
		90.9

SOURCE: *Donoghue's Money Fund Report*, December 6, 1982, as given in Rosenblum and Siegel, Table 13.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 16

Profitability of Insured Commercial Banks: 1952-1980

Year	Net Income as Percent of		
	Total Assets	Total Capital	Equity Capital
1952	0.55	8.07	
1953	0.55	7.93	
1954	0.68	9.50	
1955	0.57	7.90	
1956	0.58	7.82	
1957	0.64	8.30	
1958	0.75	9.60	
1959	0.63	7.94	
1960	0.81	10.02	
1961	0.79	9.37	
1962	0.73	8.83	
1963	0.72	8.86	
1964	0.70	8.65	
1965	0.70	8.73	
1966	0.69	8.70	
1967	0.74	9.56	10.14
1968	0.72	9.70	10.31
1969	0.84	11.48	11.98
1970	0.89	11.89	12.37
1971	0.87	11.85	12.39
1972	0.83	11.60	12.25
1973	0.85	12.14	12.86
1974	0.81	11.89	12.53
1975	0.78	11.19	11.75
1976	0.70	10.66	11.41
1977	0.71	10.93	11.72
1978	0.77	11.96	12.80
1979	0.81	13.01	13.89
1980	0.80	12.85	13.66

SOURCE: FDIC *Annual Report*, various issues.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 17

Financial Services Offered by Banks and Other Financial Firms: Who Does What According to Citibank

Activities	Banks	Other Financial Firms
1. Take Money/Pay Interest	X	X
2. Check Writing	X	X
3. Loan	X	X
4. Mortgage	X	X
5. Credit Card	X	X
6. Interstate Branches		X
7. Money Market		X
8. Securities		X
9. Life Insurance		X
10. Property Insurance		X
11. Casualty Insurance		X
12. Mortgage Insurance		X
13. Buy/Rent Real Estate		X
14. Cash Management Account		X
15. Travel Agency/Service		X
16. Car Rental		X
17. Data Processing (General)		X
18. Telecommunications		X

SOURCE: Citibank, *Old Bank Robbers Guide to Where the New Money Is*, pp. 22-23.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Bibliography

Aharony, Joseph and Itzhak Swary, "Effects of the 1970 Bank Holding Company Act: Evidence from Capital Markets, "Journal of Finance, vol. 36 (September 1981), pp. 841-53.

Atkinson, Thomas R., Trends in Corporate Bond Quality (New York: National Bureau of Economic Research, 1967).

Benston, George J., Gerald A. Hanweck, and David B. Humphrey, "Scale Economies in Banking: a Restructuring and Reassessment," Journal of Money, Credit, and Banking, vol. 14 (November 1982), pp. 435-56.

Bleeke, Joel and James Goodrich, "Capitalizing on Opportunities Created by Deregulation of the Banking Industry, "McKinsey & Company, Inc., September 1981.

Board of Governors of the Federal Reserve System, The Bank Holding Company Movement to 1978: A Compendium (Board of Governors, 1978).

Boyd, John H., Gerald A. Hanweck, and Pipat Pithyachariyakul, "Bank Holding Company Diversification," in Proceedings of a Conference on Bank Structure and Competition (Chicago: Federal Reserve Bank of Chicago, 1980), pp. 105-21.

Christophe, Cleveland A., Competition in Financial Services (New York: First National City Corporation, 1974).

Citicorp, Old Bank Robbers' Guide to Where the New Money Is, pamphlet, undated.

Eisenbeis, Robert A., "Bank Holding Companies and Public Policy," in Financial Services: The Changing Institutions and Government Policy, edited by George J. Benston (Englewood Cliffs, N.J.: Prentice-Hall, 1983), forthcoming.

Eisenbeis, Robert A., Robert S. Harris, and Josef Lakonishok, "Benefits of Bank Diversification: the Evidence from Shareholder Returns," unpublished paper, October 1982.

Flannery, Mark J., "A Method for Empirically Assessing the Impact of Market Interest Rates on Intermediary Profitability," in Proceedings of a Conference on Bank Structure and Competition (Chicago: Federal Reserve Bank of Chicago, 1980), pp. 1-15.

-------, "How Do Changes in Market Interest Affect Bank Profits?" Business Review, Federal Reserve Bank of Philadelphia (September/October 1980), pp. 13-22.

Ford, William F., "Banking's New Competition: Myths and Realities, "Economic Review, Federal Reserve Bank of Atlanta (January 1982), pp. 3-11.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Hickman, Braddock, Corporate Bond Quality and Investor Experience, National Bureau of Economic Research, Studies in Corporate Bond Financing, No. 2 (Princeton, N.J.: Princeton University Press, 1958).

Jacobs, Donald P. and Almarin Phillips, "Reflections on the Hunt Commission," in Financial Services: The Changing Institutions and Government Policy, edited by George J. Benston (Englewood Cliffs, N.J.: Prentice-Hall, 1983), forthcoming.

Jones, Sidney L., The Development of Economic Policy: Financial Institution Reform (Ann Arbor, Michigan: University of Michigan, 1979).

Rhoades, Stephen A., "The Effect of Bank-Holding-Company Acquisitions of Mortgage Bankers on Mortgage Lending Activity, "Journal of Business, vol. 48 (July 1975), pp. 344-48.

-------, The Performance of Bank Holding Companies in Equipment Leasing," Journal of Commercial Bank Lending, vol. 63 (October 1980), pp. 53-61.

Rhoades, Stephen A. and Gregory E. Boczar, "The Performance of Bank Holding Company-Affiliated Finance Companies," Staff Study 90 (Board of Governors of the Federal Reserve System, Division of Research and Statistics, 1977; processed).

Rosenblum, Harvey and Diane Siegel, "Competition in Financial Services: The Impact of Nonbank Entry," Staff Study 83-1, Federal Reserve Bank of Chicago, 1983.

Smith, Lee, "Merrill Lynch's Latest Bombshell for Bankers," Fortune, April 19, 1982, pp. 617-72.

Stover, Roger D., "A Re-Examination of Bank Holding Company Acquisitions," Journal of Bank Research, vol. 13 (Summer 1982), pp. 101-08.

Talley, Samuel H., "Bank Holding Company Performance in Consumer Finance and Mortgage Banking, "Magazine of Bank Administration, vol. 52 (July 1976), pp 42-44.

Weisbrod, Steven, "Economies of Scale in Commercial Banking," unpublished paper, 1980.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis