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**Challenges Facing Bankers  
or  
Are Banks an Endangered Species?**

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**The Bank Leadership Institute**  
Sponsored by the Ohio Bankers Association

12:00 p.m. to 1:30 p.m.  
**Friday, September 19, 1997**  
Public Square Meeting Room  
KeyCorp Tower -- 21st Floor  
Cleveland, Ohio

## **Background Notes**

The agenda for the program is enclosed.

The morning speakers from the Fed include:

Mark Sniderman	"Monetary Policy"
Larry Cuy	"Technology in the Future"
Steve Jenkins	"Banking Supervision and Regulation"
Bob Ware	"Roles of the Federal Reserve"

You are scheduled to speak at the luncheon.

Debbie Miller will introduce you. She is in charge of the Bank Leadership Institute.

No news media will attend.

A class list is enclosed. Participants are typically AVPs, VPs, and branch managers from community banks. Dennis Todd Sheets, one of our bank examiners, is in the class.

## **Enclosures**

Agenda

List of the Class of 1997-98 -- Bank Leadership Institute

## I. Introduction

- A. Acknowledge introduction by Debbie Miller.
- B. I'm very pleased to have this opportunity to address the Bank Leadership Institute. Educational opportunities for bank leaders, such as the Bank Leadership Institute provides, are increasingly important because of the numerous strategic issues facing bank executives.
- C. The focus of my remarks today is fundamental challenges facing banks and bankers.
  - 1. As Bob Dylan sang in the 1960s, "The times they are a-changin'."
  - 2. Of course, things have always been changing, but they are changing faster today, especially in financial services.
  - 3. The question is, will bankers and banks respond to those changes and prosper? Or, will they fail to respond, and die out like the dinosaurs? And the ice cutters?
  - 4. You already know about dinosaurs, but let me tell you a bit about the ice cutters.
    - a. The U.S. Ice Trust was a major employer when the 20th century began. They cut ice in winter, stored it, and delivered it for use in the ice boxes that people used to keep food from spoiling.
    - b. Ice cutters became extinct because they thought their **function** was to cut and deliver ice. Actually, their function was to help people keep fresh food from spoiling.
      - (1) So, they didn't understand the strategic significance of the advent of electrical

refrigeration technology.

- (2) I wonder if today's refrigerator manufacturers will respond to the development of irradiation technology for keeping fresh food from spoiling? Will they, or someone else, be the ones to sell food irradiation devices for home use? I would welcome such a device because, except for ice cream and an occasional beer, there is very little in my refrigerator that I want to consume cold.

- D. Here are some of the fundamental changes and challenges facing bankers.

## II. Defining a Bank

- A. First of all, what is a bank? Here are some definitions:

1. Most people: A place to store/borrow money.
2. Legislation: Company that accepts deposits and makes commercial loans.
3. Courts: Company whose balances are convertible into F.R. Notes.
4. Bankers: An institution with a bank charter that is subject to burdensome regulation and a non-level playing field.
5. Is a company **with** a bank charter a bank if, like MBNA, it limits its business to credit cards?
6. Is a company **without** a bank charter **not** a bank, even if, like Fidelity(?), it holds money balances for customers and makes loans?

- B. I raise these questions to illustrate how easy it is for smart people, like yourselves, to get caught up in intellectually stimulating but strategically unimportant issues.
1. Comparing bank definitions or deciding if a particular institution is a bank is not only unimportant, it's dangerous.
  2. It's dangerous because it focuses attention on questions of organizational form and regulation rather than on the important issue of **functions** that provide value to customers.
  3. In the context of my ice cutting example, rather than debating the definition of an ice cutter, it's more fruitful to focus on better ways to help consumers prevent their fresh food from spoiling.

### **III. No Franchise is Permanent**

- A. Banks and bankers don't have immutable control over any financial services. No franchise is permanent.
- B. For a historical example, consider goldsmiths. Centuries ago, they began performing what are thought of today as banking services:
1. They accepted gold coins for safekeeping (accepting deposits).
  2. They issued warehouse receipts for the gold coins, and those receipts eventually came to be used as money.
  3. They pooled resources (customers' gold deposits) to fund loans.
  4. Those financial services continue to be provided today, but not by jewelers.
  5. Jewelers didn't have a lock on any financial services then, and

bankers don't have a lock on any financial services today.

- C. For a contemporary example, consider how bankers have lost turf in the last two decades.
  - 1. As a consequence of advances in technology, and innovations in products and marketing methods, banks have been attacked by a succession of what the retail trade calls "category killers."
  - 2. Commercial lending, mortgage lending, and all forms of consumer lending -- from automobile loans to credit cards -- are now being done by companies that specialize in these products.
  - 3. On the liability side, money market funds, equity mutual funds, and bond mutual funds all compete for household savings.
  
- D. The ongoing world trend toward deregulation and greater reliance on markets will continue to reduce the barriers that separate banks from other financial service providers.
  - 1. The collapse of communism is only the most visible example of this trend away from government restrictions on private economic activities.
  - 2. In addition to the U.S., it is happening in South America, Japan, England, and even in China.
  - 3. New Zealand is a great example:
    - a. The statutory distinction between bank and non-bank financial service providers is being ended.
    - b. The regulatory distinction between deposit and other liabilities is being ended.
    - c. In this new environment, a firm such as a telephone

company could offer transferable, interest-bearing credit balances and have a settlement balance at the central bank.

- d. Would that make the telephone company a bank? That is not a useful question, because nothing depends on the answer.
4. In the U.S., the regulatory walls imposed in the 1930s to separate commercial banking from investment banking, insurance, and brokerage activities are being removed and/or made irrelevant by technology and market forces.
- E. Just as no franchise is permanent, no combination of financial services is unthinkable. Financial services can be bundled together by providers into any number of new combinations.

#### **IV. Bank Location**

- A. Another challenge for bankers concerns location. Bank location is changing because of two new developments:
  - 1. Legalization of interstate branching.
  - 2. Electronic banking.
- B. For Federal Reserve Banks, interstate branching raises many questions.
  - 1. Statutes and regulations are full of language that refers to geography -- main office; head office; main branch; lead bank.
  - 2. In the future, should a bank's legal address be where it is chartered? Or where it is incorporated? Or where it has most of its workers? Or where its CEO spends most of his time? Or the address on its stationery? Or where it has the largest

concentration of assets?

3. Location affects where a bank keeps its Fed reserve account. Where it has its Fed membership. Where it is supervised. Which Reserve Bank's discount window it borrows from. And what community (ies) it must serve for CRA purposes.
  4. However, these issues are **not of fundamental** importance to bankers. Long run survival will not be determined by the answers to these questions.
  5. For bankers, what is important is that interstate branching means they will have even more competitors than they have now.
- C. An much bigger locational challenge for bankers is the increase in electronic provision of financial services.
1. Most banks have ATMs. Although available 24 hours a day, their range of services is fairly limited, customers must travel some distance to the machine, and customers aren't comfortable using them while dressed in pajamas.
  2. But a bank that is open around the clock, and whose address begins with **1-800** or ends in **dot com**, is another matter. These kinds of electronic banking make distance, time of day, and whether I'm in pajamas, irrelevant for many financial services. So, competition and market area become nation-wide, or more.
  3. As more customers become willing to give up face-to-face contact in order to have these conveniences, the competitive pressure to provide services electronically will increase.
  4. And that will lead to another challenge: The risk that banking services could become commodities.

## V. The Fundamental Challenge of Internet Banking

- A. The advent of Internet commerce, including Internet banking, raises the question: Will banks be **in** the Internet shopping mall, or will they be the mall?
1. The answer depends on who owns the “gateway” to Internet commerce.
- B. If a bank does no more than offer its products on the Internet, search engines will enable customers to compare its interest rates and fees with those of all other banks that have Internet sites.
1. In that case, the asset and liability products of banks would become as indistinguishable from one another as men’s dress shirts imported from China, Indonesia, Pakistan, and Thailand.
  2. Standard bank products would become commodities, where price is the primary focus of competition.
  3. The bank would be just another storefront in someone else’s electronic mall.
- C. But, if a bank provides its customers **access** to Internet commerce, that is, if it “owns” the fundamental customer relationship, then the bank is the mall.
1. It would then be in a position to provide, and charge for, the payments services involved in Internet shopping transactions.
  2. It could charge for time that customers spend in the mall.
  3. It could assist customers to glean information from the mall, and charge for that assistance.
  4. And it would be in an advantageous position for advertising its banking products and services to customers.

- D. If banks own Internet malls:
1. To “go to the bank” might mean to “log on” to your information/transactions service provider.
  2. To “do your banking” might mean “to seek information about alternative products, services, and investments [go shopping] and then arrange for the acquisition of products, services, and investments [make payment].”

## VI. Payments Services

- A. Until recently, payments services had been the last remaining exclusive franchise of banking.
- B. Now, the emergence of Internet commerce and stored-value cards -- such as Mondex -- means that companies without bank charters may be offering payments services.
- C. To “make a deposit” or “make a withdrawal” could come to mean to transfer a balance from one electronic storage device to another electronic storage device.
- D. To “make a payment” could come to mean to transfer a credit balance [held in the form of (1) a stored value card; (2) a liability of a financial firm (or even a non-financial firm); (3) or an electronic record in a personal computer] from one person or business to another person or business.
- E. The U.S. Postal Service is studying how it might enter the payments business. The Congressional mandate that all Treasury payments be made electronically by 1999 gives the Post Office a rationale for entering the business, because 10 million recipients of government checks do not have bank accounts.

- F. The extent to which banks will participate in these emerging payments mechanisms will depend on:
1. How much protection Congress and bank regulators provide for banks.
  2. How aggressive and innovative banks are in using these emerging technologies to provide payments services that customers value.

**VII. Deposit Insurance** [Note to Jerry: I don't find the argument in this section to be persuasive. The subsidy to banks implicit in deposit insurance does provide Congress with a rationalization for using banks as instruments of social policy. However, the elimination of that one excuse is unlikely to cause Congress to stop using banks as instruments of social policy. The benefits to Congress from imposing unfunded mandates are too great. The Americans with Disabilities Act and the Family Leave Act are examples of unfunded mandates that do not have the deposit insurance subsidy as a rationalization. Gerry.]

- A. Another challenge for bankers is to **get rid of** deposit insurance. Yes, I said **get rid of**.
- B. Let me explain why should bankers view deposit insurance as a problem.
1. A couple of years ago, a member of Congress was asked why he supported some of the regulatory burdens imposed on banks. He replied, "because it is a way of doing good without it costing anyone anything."
  2. Of course, just because it is not appropriated by Congress does not mean that it is free.
  3. The Congressman's response reflects a view that is widely held in political circles -- namely, that banks are instruments for

implementing social policies.

4. The rationalization for that view is that banks have access to deposit insurance and other parts of the financial safety net. That access is a subsidy from society, so it is justifiable to impose on banks the burdens of achieving certain social objectives.
- C. Giving up deposit insurance is necessary if banks are to be relieved of some of the burdensome requirements imposed by Congress that other financial service providers do not carry.

## VIII. Conclusion

- A. Let me conclude by summarizing.
1. The financial services industry is changing rapidly.
  2. In responding to change, the critical thing is to understand the fundamental **functions** that customers want help with.
  3. The definition of a bank is unimportant.
  4. No financial services franchise is permanent.
  5. Financial services can be bundled together in any number of new combinations.
  6. Electronics and silicon chips are making possible radically new delivery systems for financial services.
  7. Electronic banking reduces the importance of bank location and increases the competition among banks.
  8. Internet banking could result in bank products becoming commodities. Or, Internet commerce could give banks several

new sources of fee income.

9. In this changing environment, the financial service firms and executives who prosper will be those whose thinking about organizational forms, combinations of services, and delivery methods is not constricted by their knowledge of the ways that things are done today. Prosperity will go to those who recognize what **fundamental financial functions** they are providing to customers.

B. Now, I'll be glad to take a few questions.