(UALR397 rev.)

The Functions and Future of Banking

remarks by

Jerry L. Jordan
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

OBA Leadership Institute
Federal Reserve Bank of Cleveland
September 15, 2000

Former Federal Reserve Gov. John LaWare: "commercial banking will always be done; not certain banks will be allowed to compete in that business".

- that had to sound confusing to a lot of people;

but, it served to emphasize that we will have to change the concepts and the language we use to talk about financial services in the 21st century

- Bank of Japan/Reserve Bank of Australia conferences--Reserve Bank of New Zealand:

    --no more on-site examinations

    --legislation to end statutory distinction between bank & non-bank financial service providers

    --end of regulatory distinction between deposit & other liabilities

        [arbitrary distinction used to set "deposit insurance"]

    --question: phone company offers transferable, interest bearing credit balance?

        --answer: we expect

    --question: phone company requests settlement balance at Reserve Bank?

        --answer: we expect

    --question: phone company is a bank?

        --answer: not useful question; nothing depends on answer.

At the heart of the issue is a simple question: What is a bank?

Already a second question is starting to be troubling--Where is the bank?

<u>bank:</u> noun (place)--**<u>the</u>** bank, **<u>a</u>** bank

most people: word bank: place to store money/borrow money

legislation: accepts deposits **<u>and</u>** makes commercial loans

[Granddaughters: ?Non-bank bank?]

courts: FSU, balances on stored value cards convertible into F.R. Notes illegally engaged in business of banking

Savings & Loans	FR BOD
Morgan Stanley	Class A, B, C
Charles Schwab	

future: verb (activity)--<u>to bank</u> [?non-banking activity?]

- In the past, under the Bank Holding Company Act-- "closely related to banking"

(Jewelry store) (first bankers)

- In the future: Chairman Leach -- "financial in nature"
- regulatory definitions are important:

  -1970s--credit card/mmf

  --travelers cheques

- "Deposit" word used to apply regulations--Reg. Q (until 1986)
- still used to apply Reg. D (reserve requirements), deposit insurance

Future: smart cards/stored value cards--load the card--**withdrawal** or **advance**?

Visa, Atlanta: "unlike others, no money <u>on</u> the card; only a claim to a money balance" [?is the balance on the card the electronic equivalent of a Federal Reserve Note? Or, the electronic equivalent of a travelers cheque?]

- **people:** "I deposited my money in a Fidelity money market fund"
- **Fed economist:** "two mistakes; not money & not deposit"
- **people:** "oh?; well, I just deposited my money in a Fidelity MMF!"

Statutes and regulations are full of language that refer to geography: where the "bank" is "located"

- lead bank; main office; head office; main branch;

Bank Holding Company Act: where largest concentration of assets is held!

I'm not sure where a financial services company will have physical facilities in the future, but, when someone asks one of my granddaughters for the address of their bank, the bank's address will end with **dot com**

Banking--What businesses?

I am fairly certain that 10 years ago even bankers would not have expected that the Berlin Wall would come down before the Glass-Steagall wall that has subdivided the financial services industry into 60-year old boxes.

I'm convinced that innovations in information and communications technologies will alter the financial services industries just as certainly as they forced the end of the "Iron Curtain/Berlin Wall".

The 1930s represented a watershed decade around the world. In the wake of a worldwide economic depression, the response in many countries was to greatly increase government intrusion into such decisions as what could be produced and where, how much things would cost, how much could be paid for labor, what interest rates could be paid or received, and even how much profit could be earned.

Consider some of the by-products of that decade: (10-12 years, teacher-granddaughters looking back at 20th Century)

- for more than 40 years, it was illegal for Americans to own gold; **[dumb]**
- for 50 years, the government set a maximum interest rate that people were allowed to earn on their savings; **[dumb]**
- arbitrary regulations made it uneconomical for banks to issue traveler's checks; **[currency vs. Deposit] [dumb]**
- some institutions could make mortgage loans, but not car loans; some institutions allowed individual savings accounts, but not checking accounts; withdrawals were made only in currency or in a check that you then deposited into another institution so you could write a check to pay for something; **[dumb]**
- with ATM's across the state line, you could make a withdrawal from your account, but you could not make a deposit. **[dumb]** (That finally changed June 1, 1997.)

Sometimes it seems as though the innovations in information and communications technologies were an irresistible force that were up against the immovable object of regulations.

For the past two decades, at least, legislation and regulation have been lagging behind the persistent pressures of technology and innovations in a competitive marketplace. As a consequence -- to use an analogy from the retail trades -- banks have been attacked by a succession of 'category killers'. Banks no longer have an exclusive franchise on any type of loan products. Commercial lending, mortgage lending, and all forms of consumer lending -- from automobile loans to credit cards -- have been attacked by companies specializing in these products. On the liability side, money market funds, and equity and bond mutual funds, all compete for household savings.

Until recently, payments services had been the last remaining exclusive franchise of banking. Now, the emergence of the Internet and 'stored-value cards' (or 'smart cards') means that even transactions services may be offered by companies that do not have a bank charter like Cybercash. Stored-value cards -- such as 'Mondex' -- might be thought of as electronic traveler's cheques. Or, the balances stored on these cards may be private-sector substitutes for Federal Reserve Notes (currency). That would put the issuers of such cards in the money creation business. When legislators and regulators decide what is on those cards --- whether money or "claim to money" they will be deciding who will be competitive in offering them.

In Europe, current thinking is that only commercial banks may issue these 'cash cards', with one notable exception -- telephone companies.

In 1998, Motorola began delivering a cellular telephone that has a slot to insert a smart card so you can dial a local number and download a balance from somewhere onto the card -- not more trips to the ATM!

Whether banks in the United States will be the exclusive -- or even the dominant -- suppliers of this new form of money is yet to be determined. Future legislation and regulation will address issues such as insurance, reserve requirements, capital requirements and various consumer protection concerns. The effect will be to greatly influence the economic viability of banks versus other potential competitors.

If banks own the Internet mall, then when my granddaughters **'go to the bank'** they will be doing what we currently call **'To log on'** to your information/transactions service provider. Conventional expressions we use would take on new meanings:

1) to "make a deposit" or "make a withdrawal" would mean to transfer a balance from one electronic storage device to another electronic storage device.
2) to "make a payment" would mean to transfer a credit balance [held in the form of (a) stored value card; (b) liability of a financial firm; (c) electronic record in a personal computer from one person or business to another person or business.

Activity of banking includes: information services ("shopping") & transactions services ("payments")

This broader vision of electronic commerce of the future suggests that to engage in the **activity of banking** would come to mean: "**to seek information about alternative products, services, and investments [shopping], then arrange for the transfer of ownership of those products, services, and investment assets [payment].**"

Needed: New Image for Banking

Most people have heard the response of the famous bank robber, Willie Sutton, when asked why he robbed banks: "Because that is where the money is."

We can be certain that in the future "to rob a bank" will evoke images of something different than men wearing masks and pointing guns at tellers.

Not only will bankers need to think and talk differently, but their customers will have to be re-educated about the services they <u>expect</u> to obtain from their bank.

At the turn of the century, one of the largest employers in America was the U.S. Ice Trust, which cut, stored, and delivered ice for people's "iceboxes." That industry doesn't employ many people now, although it's not because people have abandoned the desire to keep fresh food cold. Rather, a product born of new technology, the refrigerator, entered American homes and all but eliminated the need for ice cutters.

What happens to the retail commercial banking industry in the coming decades depends on how successfully banks can provide value to their customers. The challenge for both managers and banking supervisors is to understand what customers want --to distinguish between cutting ice and keeping food cold. I believe the best way to do this is to think clearly about the *services* or *functions* that people demand, and then ask whether banks (as we know them today) have a comparative advantage in supplying them.

Looking at the value-adding activities of banks provides a framework for thinking about profitable opportunities and a way to assess the competition coming from other banks, money market funds, or even the phone company or a computer software company.

Banks enable their customers to transfer resources across time and space. More specifically, the financial system performs six broad functions:

1) Conducting exchange: clearing and settling claims
2) Funding large-scale enterprises: resource pooling
3) Transferring purchasing power across time and distance
4) Providing risk management: hedging, diversification, and insurance
5) Monitoring performance of borrowers: mitigating adverse incentives
6) Providing information about the relative supply of and demand for credit.

Commercial banks perform all of these functions, but other organizations clearly do so as well. In a well-functioning economy, people make payments, borrow money, save for the future, and insure themselves, but they don't necessary need a chartered bank to do those things.

Using the functional perspective, a bank (or the business of "banking") is a particular combination of functions. Functionally, in the 20th century, a commercial bank has been a business that funded itself with liquid liabilities and made illiquid loans. Legally, a commercial bank is a corporation that receives a banking charter and is subject to the rules and regulations thereof.

This statutory definition prompts two important observations. First, the functional definition of "banking" is not synonymous with the legal definition. Thus, a financial holding company owning a finance company, a venture capital firm and a money market mutual fund has a fair claim to be called a "bank" from a functional standpoint, even if it does not have a bank charter. Likewise, a chartered bank that specializes in global custody arrangements or serves as a clearinghouse for credit cards is functionally not a bank. Second, "commercial banks" need not exist, and may disappear. Someone will perform the functions now provided by banks: on the liability side, payments, pooling, and risk management; and on the asset side, resource transfers and risk management. But this particular combination need not necessarily survive, just as Goldsmiths -- who combined making metal jewelry and taking deposits no longer exist.

In the future, firms may serve customers by bundling certain financial services that are not currently combined, or they may merge banking-like services with non-banking-like services, such as tickets to concerts and sporting events, and vacation planning. These firms may have electronic delivery vehicles and may be accessed through the Internet. In the end, prosperous firms will be those that find ways to deliver services the public wants. Some activities that today we regard as inappropriate, difficult, or illegal for banks will change, and sooner than many people now expect.