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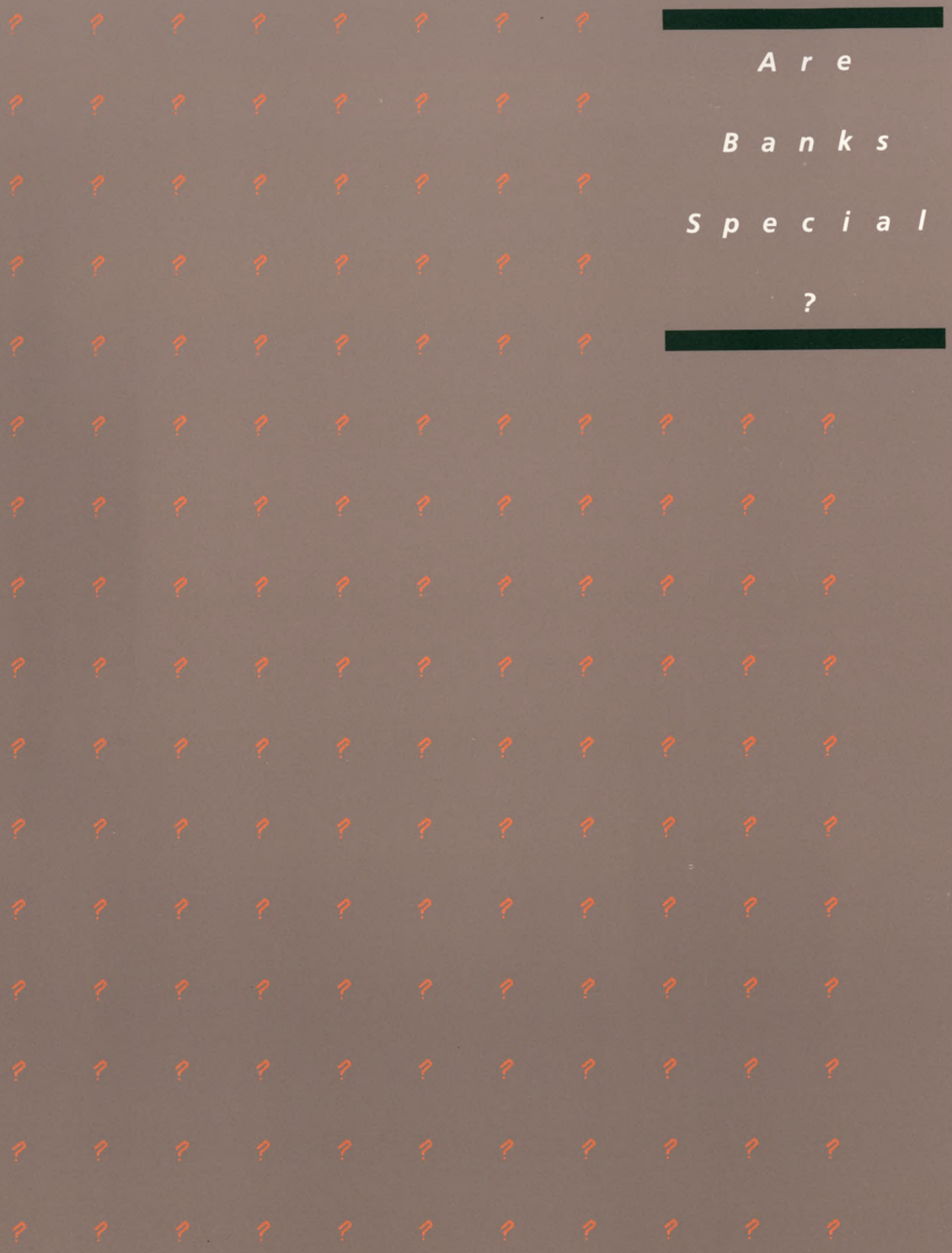
Are Banks Special?



President's Message

It has, for some time, been the practice of the Federal Reserve Bank of Minneapolis to devote its Annual Report to an essay on a banking, financial, or an economic issue of particular importance. In keeping with that tradition, this Bank's 1982 Annual Report examines a seemingly straightforward but, in fact, very complex question: Are banks special?

The subject of this year's essay is both timely and important in that it goes to the core of issues that underlie the appropriate scope of banking powers, bank ownership and control, and the structure of banking organizations.

The essay does not, nor is it intended to, provide a roadmap for legislative or regulatory actions. Rather, it seeks to provide a perspective on the basics of banking; basics which should weigh heavily in deliberations about the future of specific banking functions and the special role of banking organizations.

E. Gerald Corrigan
President

Are Banks Special? A Summary

Absent a satisfactory understanding of what it is — or was — that makes banks special in a functional sense, it is very difficult, with any degree of consistency, to answer questions about the separation of banking from other lines of business, the scope of banking powers, the ownership and control of banks, and banking structure more generally.

This essay seeks to shed light on these issues by stepping back from current institutional, regulatory, and legal arrangements and attempting to identify the essential functions of banks.

The essay suggests that banks perform three essential functions: (1) they issue transaction accounts (i.e., they hold liabilities that are payable on demand at par and that are readily transferable to third parties); (2) they are the backup source of liquidity to all other institutions, financial and nonfinancial; and (3) they are the transmission belt for monetary policy.

On close inspection, it becomes evident that these essential functions are highly interdependent and that banks' ability to perform such functions dictates the need for a high degree of public confidence in the overall financial condition of banks — and especially the quality of banks' assets.

This dictate has been reinforced by a public safety net — deposit insurance and access to the lender of last resort — which is uniquely available to "banks." The presence of that public safety net implies unique public responsibilities on the part of banks and would further seem to imply that if we are no longer willing or able to segregate essential banking functions into an identifiable class of institutions, then the public safety net should be made universally available to any institution that provides a banking function, or it should be eliminated altogether.

Against this background, the essay goes on to suggest a definition of a bank. The definition is deceptively simple: a bank is any institution that is eligible to issue transaction accounts. If an institution meets this definition, it would (1) be eligible for government deposit insurance; (2) have direct access to the discount window; (3) be subject to reserve requirements; and (4) have direct access to Federal Reserve payment services, particularly the wire transfer system.

Four important implications emerge from the essay's analysis of essential bank functions and the associated definition of a bank.

First, if preserving essential bank functions really does matter, it follows that banks must be competitively viable.

Second, there is room for broader bank powers. The expansion of those powers must, however, take place within a context that guards against excessive risk-taking by banks and insures the impartiality of the credit decision making process.

Third, once agreement has been reached on appropriate banking powers, questions about bank ownership and control become easier to answer. Certainly logic would suggest that particular powers be vested in banks only to the extent that there is a willingness to permit another institution engaging in those same activities to own banks. By the same token, nonbanking organizations would be permitted to own banks only insofar as their activities match permitted banking activities. And if they own a bank, they would become a bank holding company.

Fourth, while there is a powerful case for placing some subsidiary banking activities into affiliates of bank holding companies on the grounds of segregating capital and providing greater protection against self-dealing, the bank holding company is not a substitute for prudent management nor is it a fail-safe device for containing risk.

Are Banks Special?

Introduction

*The recent evolution of the financial structure in the United States has produced two competing points of view regarding the proper direction for further change. On the one hand, there is the view that the "financial services industry" — encompassing banks, thrifts, brokers, investment banks, and insurance companies — should be looked at as a single entity. According to this view, efforts to distinguish among kinds of institutions are both futile and unnecessary. This view of the financial services industry is based on the belief that many financial services offered by various classes of institutions are so complementary to (or such close substitutes for) one another that institutional distinctions are rendered useless. Implicit in this view is the assumption that banks are not special.**

This "separation doctrine" in banking grew out of concerns about concentration, conflicts of interest, and appropriate risks for institutions that lend depositors' money.

The competing, if not opposing, view is that banks are indeed special. This view holds that specialization of financial institutions has worked well and, at least in some cases, specialization may still be more efficient and also better serve the public interest. This view is associated with the historical separation of banking from commerce and from investment banking. In general, this "separation doctrine" in banking grew out of concerns about concentration of financial power, possible conflicts of interest, and the appropriate scope of risks banks should incur in the face of the special trusteeship falling on institutions that engage in the lending of depositors' money. In a shorthand way, as pertains to banks and the banking system, these concerns are typically captured by the phrase, "safety and soundness."

These two points of view do not necessarily represent mutually exclusive approaches to financial market structure. For example, in the context of a large financial services holding company, banks could be legally separated from nonbanks, but it is not clear that such separation would necessarily provide the kinds of protections that are currently built into federal banking laws.

Thus, assessing the merits of these two competing views must start with some very basic questions: Are banks "special" or are they simply another provider of financial services? Does it matter what kinds of risks banks incur? Does it matter who owns banks? Is "safety and soundness" a cliche, or should it have genuine and substantial meaning for banks, for bank regulators, and for the public at large?

While banking practices have naturally evolved over time, recently a combination of events has shifted that process to one of an almost revolutionary character. Amidst this process of rapid change, with market innovation and new sources of competition, there is a perception that banks' competitive position — and presumably their market share — has slipped. Casual observation of the growth of the commercial paper market, the thrift industry, money market mutual funds (MMMFs), and the de facto trend toward ownership of banks by securities firms and commercial enterprises, tends to support that perception. Indeed, there are numerous instances in which nonbanks have been able to provide "bank-like" services at a lower cost (or a higher rate of return) to the individual or corporate customer, thereby drawing business away from banking institutions.

*In this essay, the term "bank" is used in a generic way that makes no effort to distinguish commercial banks from thrifts and other "depository institutions." This is done merely to simplify the discussion. However, in considering the essential functions of "banks" in light of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982, it is clear that in substance there are no longer meaningful differences. To be sure, differences in powers, in regulatory treatment, and in tax status remain, but the basic characteristics that distinguish banks from other classes of financial and nonfinancial enterprises now seem to apply to thrifts as well as to commercial banks.

Analysis does not bear out the perception that banks have lost ground in the domestic marketplace over the past three decades.

High on the list of reasons that are cited for this perceived shift of market position from banks to nonbank competitors is the extra burden of regulation on banks. The fact of a heavy regulatory burden on banks is beyond dispute, but in some cases it is also true that regulation — relating to, for example, deposit insurance or access to the discount window — provides powerful incentives for individuals and businesses to maintain relationships with banks. While it is difficult to judge the net competitive results of differing degrees of regulation, it does seem clear that of all the regulatory burdens on banks, there have been two that stand out in terms of their impact on banks' competitive position over time: Regulation Q and limitations on the scope of bank services. This is not to suggest that other regulations on banks — ranging from reserve requirements to community reinvestment — have not been costly. But, at the cutting edge of market position or market share, it is Regulation Q and service line restrictions that have been the most critical restraints on banks.

Despite these regulatory restraints, banks have not stood still in the face of changing financial markets and new sources of competition. By using the flexibility provided by the Bank Holding Company Act, by developing sophisticated liability management techniques, by major expansions abroad, and by creative and innovative adaptations of "conventional" banking services, banks have actually fared rather well in terms of preserving their overall market position. While it is not easy to measure what has happened to the relative position of banks over time, the appendix to this report (pages 19-24) makes such an effort. Allowing for the inherent measurement problems in such an exercise — to say nothing of the data limitations — the analysis simply does not bear out the perception noted earlier that banks have lost ground in the domestic marketplace over the past three decades. (While not captured by the data, banks have, of course, made major expansions abroad during this period.) The analysis does not, however, imply that heavy regulation has not constrained the growth of banks and their market share, for it is quite possible that absent such regulations, banks' position would have risen rather than essentially held steady. Nor does the analysis indicate whether a rising or falling bank share is good, bad, or indifferent from the perspective of the public interest. To some extent these issues depend upon whether, in fact, there is something special about banks that is worth preserving. Indeed, if banks are special, it would not be in the public interest for the features or functions that make banks special to be eroded by competitive, regulatory, or legislative forces. By the same token, if what is special about banks dictates a relatively heavy dose of regulation, public policymakers should not be goaded into eliminating necessary regulation simply because bank market share might grow to some higher level without that regulation.

What Makes Banks Special?

Reduced to essentials, it would appear that there are three characteristics that distinguish banks from all other classes of institutions — both financial and nonfinancial. They are:

As long as banks issue transaction accounts they incur, by definition, "term structure" risk.

1.Banks offer transaction accounts.

2.Banks are the backup source of liquidity for all other institutions.

3.Banks are the transmission belt for monetary policy.

These three essential bank characteristics and the interrelationships between them are discussed below. Of necessity, the discussion treats each factor separately. However, it is clear that these essential characteristics are highly complementary and furthermore that it is the relationship among them that best captures the essence of what makes banks special.

Issuance of Transaction Accounts

Only banks issue transaction accounts; that is, they incur liabilities payable on demand at par and are readily transferable by the owner to third parties. The owner of a transaction account can demand and receive currency in the face amount deposited in the account; write a check in the full amount of the account; or, perhaps most importantly, the owner of the account can transfer the full amount of the account to a third party almost instantaneously by wire transfer. The liquidity, mobility, and acceptability of bank issued transaction accounts permit our diverse economic and financial system to work with the relative ease and efficiency to which we are accustomed. Moreover, in periods of financial stress, the capacity to quickly move transaction account balances to third parties takes on special significance by providing elements of flexibility and certainty in making and receiving payments that help to insure that financial disruptions do not spread. Individual banks can also create these highly liquid and mobile balances through their lending function. The capacity to "create" liabilities with these characteristics is vital to the ongoing needs of commerce, but it takes on special significance in periods of financial stress.

Because of the peculiarities of law and regulation, not all classes of transaction accounts have the same precise legal or regulatory characteristics. The "demand deposit" is the purest form of transaction account, since, for example, negotiable order of withdrawal (NOW) accounts and some share drafts at mutual organizations have restrictions on the extent to which they are payable on demand. However, from the perspective of both the issuing institutions and their customers, these differences appear to be without substance since the accounts are perceived and treated as transaction accounts both by the issuing institution and by the public. For this reason, a contemporary definition of "transaction" accounts — at least for purposes of identifying and defining special characteristics of banks — should focus on functional characteristics rather than existing legal or regulatory distinctions. If a financial asset satisfies the functional test of being payable on demand at par and readily transferable to a third party, it should — for those purposes — be a "transaction" balance.

A case can be made that nonbank financial institutions incur liabilities that appear to have

The public safety net reflects a consensus that banking functions are essential to a healthy economy. Its presence also implies that banks have unique public responsibilities.

some or all of the characteristics of a transaction account issued by a bank. However, on close inspection it appears that such instruments — whether MMMFs, retail repurchase (RPs) agreements, customer credit balances with brokers, sweep accounts, etc. — do not, at least in a technical sense, in fact possess the characteristics associated with the bank issued transaction account. However, as is discussed later, making the distinction is particularly difficult in the case of MMMFs. In all of these cases, including money market mutual funds, instruments which appear to have bank transaction account characteristics take on those characteristics in part because the acquisition or disposition of such assets involves, at some point, the use of a transaction account at a bank. However, technology makes it possible to manage these financial assets in a way in which their ultimate dependence on a bank account is not apparent to the individual holder of the asset.

As long as banks issue transaction accounts they, by definition, incur a form of "term structure" risk. That is, the presence of transaction balances on the books of a bank makes it difficult, if not impossible, to match the maturities of assets and liabilities, particularly in a contemporary setting in which bank holdings of liquid assets have shrunk and in which some assets, traditionally considered as liquid, may not, in fact, be all that liquid. Indeed, the asset side of the balance sheet for at least some banks provides a small margin of functional liquidity that can readily be brought to bear to meet large and sudden deposit outflows. In this setting, the inherent term structure mismatch on the books of banks is one of the realities that gives rise to concerns about strains on bank liquidity and sudden drains on bank deposits.

Banks and bank regulators have long since recognized the importance of banks acting in ways that preserve public confidence in banks' capacity to meet their deposit obligations, thereby minimizing the likelihood of large, sudden drains of bank deposits. Deposit insurance and direct access to the lender of last resort are uniquely available to banks to reinforce that public confidence. Indeed, deposit insurance and access to the lender of last resort constitute a public safety net under the deposit taking function of banks. The presence of this public safety net reflects a long-standing consensus that banking functions are essential to a healthy economy. However, the presence of the public safety net — uniquely available to a particular class of institutions — also implies that those institutions have unique public responsibilities and may therefore be subject to implicit codes of conduct or explicit regulations that do not fall on other institutions.

Experience suggests rather strongly that public confidence in a bank — with or without deposit insurance and the Fed's discount window — is ultimately related to public perceptions about the financial condition of banks and specifically about the quality of banking assets, liquidity, capital, and the capacity to absorb short-run shocks. Sudden drains on bank deposits occur when depositors conclude that loan losses or other circumstances might jeopardize a bank's ability to meet its deposit obligations. The evidence is overwhelming, for example, that most "problem" bank situations in recent years involved concerns growing out of losses or perceived losses associated with lending, securities activities, foreign exchange activities, and/or poor management. In this regard, it should be noted that even when "problem" bank

situations have been resolved with a minimum of costs to the individual institution, these situations have, on occasion, involved high costs in terms of generalized financial market disruption. Thus, while deposit insurance and access to the lender of last resort may rightly be viewed as the public policy safety net under banks' deposit taking function, the integrity of the deposit taking process and therefore the strength of the public safety net process depend to a substantial degree on the prudent management and control of risks on the part of the banking system as a whole.

Public confidence in banks is ultimately related to public perceptions about the quality of banking's assets, capital, and the capacity to absorb short-run shocks.

Looked at in this perspective, the critical difference between banks and other classes of financial institutions rests with the capacity of banks to incur (and to create) liabilities that are payable on demand at par and that are readily transferable to third parties. The resulting mismatch of the maturities of assets and liabilities makes banks particularly vulnerable to sudden drains on deposits that can jeopardize their solvency. In practice, depositors — reinforced by the public policy safety net — have demonstrated tendencies to drain deposits from particular banks only when confronted with the reality or the perception of losses growing out of asset management problems and/or poor management of banking organizations. Thus, while the deposit taking function of banks is what makes them unique, the integrity of that process depends upon the risks, real and perceived, associated with the lending and related activities of the banking system as a whole and its capacity to absorb shocks in the short run.

Backup Sources of Liquidity

As discussed above, the fact that banks issue transaction deposits is the key factor that distinguishes them from other classes of financial and nonfinancial institutions. However, experience also suggests that public confidence in the ability of banks to meet their deposit obligations is ultimately related to the quality of bank assets and to the overall financial condition of the bank. This relationship takes on additional importance when it is recalled that banks can also create, through their lending activities, transaction deposits. Indeed, in a very real way, banks are the primary source of liquidity for all other classes and sizes of institutions, both financial and nonfinancial.

The extent to which banks play this role cannot be judged simply by looking at the number and value of loans on the books of banking organizations. For these purposes, contingent credit obligations of banks, such as loan commitments and standby letters of credit, must be considered in virtually the same light as direct loans. These standby credit facilities are, for example, the arrangements which permit most financial markets and institutions to function as they do. It is highly unlikely that the commercial paper market would function very well were it not for the presence of standby bank credit facilities obtained by those corporations that issue commercial paper. Similarly, it is very difficult to imagine that even the best managed and capitalized broker/dealers could handle their day-to-day business with the efficiency that is now so common without ready access to bank lines of credit. The same, of course, applies to nonfinancial corporations. Indeed, while all such institutions may, over time, have access to a wide variety of funding sources, direct or standby bank credit facilities are the cornerstone upon which these alternative sources of credit rest. If there are problems in one

In a very real way, banks are the primary source of liquidity for all other classes and sizes of institutions, both financial and nonfinancial.

segment of the credit network, institutions will simply shift their borrowing activities elsewhere in the network. However, if the problem is in the banking sector, banks must either turn to each other or to the central bank.

Even in the "normal" course of events, the direct and standby credit facilities provided by banks are the foundation upon which other credit markets depend for their vitality. This relationship takes on special significance, however, in periods of selective or generalized financial stress. For example, in virtually every case of "selective" financial shock in the 1970s and early 1980s, troubled institutions — financial and nonfinancial, bank and nonbank — turned to the banking system to provide at least a bridge until more lasting solutions to the problem could be worked out. At the very least, these bridging arrangements helped to contain problems and prevent them from spreading to other institutions or to the financial system generally.

Banks' ability to supply credit and liquidity, particularly in situations where other institutions or markets may be unwilling or unable to do so, arises because the deposit creating function of banks (in tandem with banks' relationship with the central bank) provides an element of credit and liquidity elasticity which is not immediately available to other institutions. In point of fact, the extent and frequency with which banks have had to directly rely on extraordinary funding by the central bank (either through the discount window or via open market operations) have been quite limited. In the normal course and even in periods of stress, individual banks and the banking system as a whole are able to provide necessary liquidity because of their ability to quickly fund loans through a variety of market sources including the domestic and foreign interbank market, RPs, the issuance of large certificates of deposit (CDs), and so on. For many banks, access to these markets has become the primary source of bank liquidity.

Banks' access to these markets — and by extension, banks' ability to function as backup sources of liquidity — occurs in a context in which individual suppliers of such funds — whether federal funds, CDs, Eurodollars, etc. — make judgments about the strength and vitality of individual banks and the banking system as a whole. Experience is clear, for example, that individual banks experiencing problems with classified assets, earnings, and so on, often see that phenomenon first manifest itself in the form of having to pay a risk premium over the "going" rate for federal funds and large CDs. Similarly, when concerns about the banking system arose in 1974-1975 and more recently in 1982, an early manifestation was a widening of the interest rate spread between bank and treasury liabilities of comparable maturities. In the extreme cases of severe problems with individual banks, widening spreads ultimately result in these sources of funding being cut off, with a consequent need to either contract the size of the bank, borrow from the Fed's discount window or, in some cases, close or merge the bank.

The point is, of course, that the ability of a bank to fulfill its role as a backup supplier of liquidity to the financial and business communities depends on easy access not only to traditional sources of deposit liabilities, but also to markets for nondeposit sources of

funding. The same applies to the banking system as a whole, because while one or a few banks can turn to the London market to fund themselves in times of adversity, it is clear that the banking system as a whole cannot. Thus, as with the preservation of the integrity of the deposit taking function described earlier, experience clearly suggests that the ability of banks to provide the essential function of a backup source of liquidity is ultimately dependent on market judgments as to the quality of the banks' assets and overall financial strength.

Banks are able to provide necessary liquidity because of their ready access to a variety of domestic and foreign market sources.

Looked at in this light, the ability of banks to fulfill their role as standby sources of liquidity and credit rests importantly on the quality and consistency of credit judgments made by banks. This is particularly true in periods of stress when banks may be called on to supply credit to borrowers who, for one reason or another, temporarily do not have access to other sources of funds or to make the even more difficult decisions as to which borrowers are experiencing problems of a fundamental or irreparable nature. It is in these particular circumstances that banks must be in a position to make rigorous, impartial, and objective credit decisions, because it is precisely in such circumstances that the potential for compromise in the impartiality of the credit decision making process is greatest and the potential for asset quality deterioration is the largest. It is in this light that considerations about the commingling of banking and other interests and concerns about the ownership and control of banks become compelling.

To summarize, virtually all other financial markets and other classes of institutions are directly or indirectly dependent on the banking system as their standby or backup source of credit and liquidity. Banks can fulfill this function for a variety of reasons, including their relative ease of access to deposit and nondeposit sources of funding. However, experience suggests that the capacity to provide this function or, more directly, to provide access to these markets and sources of funding — like the integrity of the deposit taking function — is ultimately related to the overall financial strength of banks and the quality of bank assets. This role of banks as a standby source of liquidity takes on special significance in periods of stress and in this light underscores the importance of rigorous and impartial credit judgments by banks. This, in turn, provides a particularly relevant context in which concerns about the commingling of banking and other interests should be evaluated.

Transmission Belt for Monetary Policy

As the preceding discussion suggests, there is a direct link between banks and the central bank arising in part from the central bank's lender of last resort function. More broadly, the fact that banks are subject to reserve requirements places the banking system in the unique position of being the "transmission belt" through which the actions and policies of the central bank have their effect on financial market conditions, money and credit creation, and economic conditions generally. To put it somewhat differently, the required reserves of the banking system have often been described as the fulcrum upon which the monetary authority operates monetary policy. The reserves in the banking system also serve the complementary purpose of providing the working balances which permit our highly efficient financial markets to function and to effect the orderly end-of-day settlement of the hundreds of billions of dollars of transactions that occur over the course of each business day.

Banks must be in a position to make rigorous, impartial, and objective credit decisions.

Some have argued that neither monetary policy nor the payments mechanism are dependent on the relationship between reserves and the banking system. There have been, or are, schemes for conducting monetary policy and operating a payments mechanism that do not use bank reserves and the banking system in the way the U.S. system currently operates. However, it is also true that any of these alternative arrangements would entail major institutional changes and run the risk that they might not work as efficiently as the current framework or the possibility that they might not work at all. In short, to justify departure from the current arrangement the weight of evidence should be overwhelming that the current system is not working or that some alternative system would work decidedly better.

In fact, the current system seems to work rather well, although recent developments may have introduced elements of slack into the transmission belt. For example, the proliferation of close substitutes for bank-issued transaction accounts narrows the effective scope of reserve coverage. The narrowed reserve coverage can introduce more slippage into the process of monetary control, and it also means that a relatively smaller reserve base is supporting a larger flow of payments. Similarly, the deregulation of the liability side of banks' balance sheets seems to imply that, in order to achieve a given degree of monetary restraint, a higher level of market interest rates is required than might otherwise have been the case. Further, increased leverage of banking organizations may work in the direction of introducing slippage into the monetary control process, in that a larger volume of credit flows may be associated with some given rate of growth of "money." Finally, higher leverage and greater risk exposure may weaken the capacity of the banking system to adjust to and to absorb the changes in credit market conditions that must accompany periodic monetary restraint.

As suggested above, these and other forces may already be working to introduce a larger margin of slack into the transmission belt. While the slack evident today is of manageable proportions, the future design of the banking and financial system must leave intact a strong yet adaptable mechanism through which monetary policy and the payments mechanism can function. This imperative underscores the case for attempting to segregate essential banking functions into an identifiable class of institutions and seeking to ensure that these institutions have the financial strength and vitality to perform their essential functions and to absorb changes in the credit market and economic conditions associated with periods of monetary restraint.

Defining a Bank

From the previous discussion, it should be clear that there are in fact certain special and unique functions of banks and that they are essential to the functioning of an efficient and safe financial and economic system. However, it also seems likely that if "banks" did not provide these essential functions, someone else would — just as it is abundantly clear that the process of market innovation has already produced services which are close substitutes for essential bank services. Given these considerations, the threshold question that arises is whether it is still desirable, from a public interest point of view, to attempt to segregate essential banking functions into an identifiable class of institutions and, if that is the case,

whether it is possible to define a bank in a manner that is both functionally and intellectually satisfactory.

Banks are in the unique position of being the transmission belt for monetary policy. Recent developments may have introduced elements of slack into that belt.

Putting aside for the moment practical problems of definition, it would seem that the case for segregating essential banking functions into an identifiable class of institutions is every bit as powerful today as it was in the 1930s. If anything, concerns regarding financial concentration, conflicts of interest, and the fiduciary responsibilities associated with lending depositors' money may be more relevant today than they were 50 years ago. To be sure, the lines of distinction may not have to be drawn in the same way and in the same place that they were in the past, but the earlier discussion of the essential functions of banks serves as a powerful argument for separation at some point. Indeed, to reject the notion of separation would — as a matter of logic — require that deposit insurance and access to the lender of last resort, together with the associated supervisory and regulatory apparatus, either be done away with altogether or be made universally available to any institution that provides essential banking functions — irregardless of what other types of business or commerce it might be engaged in. However, as a practical matter, the case for separation is only viable if we are able to provide a satisfactory definition of a bank.

Over time, a variety of tests have been used for the purpose of defining a bank. These tests ranged from a charter test to the functional test of issuing demand deposits and making commercial loans. At one time, each of these tests was satisfactory. However, currently neither existing statutes nor regulations seem to contain a definition that is satisfactory.

A satisfactory definition of a bank must start with a clear recognition of the essential functions provided by such institutions. From the earlier discussion, it is clear that the single characteristic of banks that distinguishes them from other classes of institutions is that they issue transaction accounts; that is, accounts that in law, in regulation, or in practice are payable on demand at par and are readily transferable to third parties. A powerful case can be made that the definition of a bank should stop right there: a bank is any organization that is eligible to issue transaction accounts. If an institution meets this test, it would (1) be eligible for government deposit insurance; (2) have direct access to the discount window; (3) be subject to the Fed's reserve requirements; and (4) have direct access to the Federal Reserve's payments services, particularly the wire transfer system. For these purposes, an appropriate statute would have to redefine transaction accounts. At a minimum, such a definition would have to include conventional demand deposits, NOW accounts, and share drafts. It might also include the new money market deposit accounts (MMDAs) and, depending on the standards of definition, perhaps even MMMFs or other nonbank institutional arrangements that provide "check" writing capabilities.

On the surface, this definition of a bank may seem inadequate because it contains no corollary asset or lending test; it focuses only on the liability side of the balance sheet. This seeming inadequacy arises in part because the current Bank Holding Company Act's definition requires that a bank issue demand deposits and make commercial loans. More substantially, the absence of a lending test seems to fly in the face of arguments made earlier

To reject the notion of separation would logically require doing away with — or making universally available — deposit insurance, the discount window, and supervision/ regulation.

concerning the critical link between the deposit taking function and the lending or asset acquisition functions of banks. However, it is precisely because of the nature of the relationship between deposit taking and asset acquisition that the essential definition of a bank should be couched in terms of its deposit taking function — without regard for the particular distribution or classification of its loans and/or investments. Taken by itself, there is nothing unique or special about the asset side of a bank's balance sheet, except for the limits on the scope of asset acquisition powers discussed below. Concerns about the nature and risk characteristics of bank assets arise in the context of the unique nature of bank liabilities, the need to preserve the integrity of the deposit taking function, and the special trusteeship growing out of that function. Thus, while it may be appropriate from the standpoint of public policy to limit the asset powers of banks to certain less risky activities, the definition of a bank need only deal with the liability side of the balance sheet.

The absence of an asset test might, however, create a definitional loophole. That is, "banks" could conceivably refrain from issuing transaction deposits while funding their asset acquisition activities with insured time and savings deposits. However, this problem could be minimized by reliance on such an institution's eligibility to issue transaction accounts. If so eligible, it would be defined and regulated as a bank even though, in practice, it refrained from issuing transaction accounts. An institution that was not eligible to issue transaction accounts would not be a bank and would not be eligible for deposit insurance, access to the Fed, and so on.

By this definition, existing commercial banks, thrifts, and credit unions would be considered "banks." Similarly most of the "nonbank" banks formed in recent years under the Bank Holding Company Act (by not engaging in commercial lending) would be banks, as would, depending on state laws, some "industrial" banks. Treating thrifts and certain other institutions as "banks" raises a host of difficult and politically charged issues relating to regulatory treatment, tax status, divestiture, and grandfathering arrangements. However, for purposes of this discussion, the fact that certain "nonbank" financial institutions are, for a variety of reasons, banks does not require immediate or perhaps even parallel regulation. Rather, the suggestion would be that there is an essential core of regulation that should apply more or less equally to this broader class of institutions which provides essential banking functions.

The issue of whether money market mutual funds fit the definition of a bank — even at a conceptual level — is not so easy to deal with. Many such funds certainly appear to have all the characteristics of bank transaction accounts. In the case of the money market mutual fund, the critical distinction relative to a bank transaction account appears to be the extent to which the liabilities in question are payable at par. In the case of a bank deposit, deposit insurance, the capital of the bank, and the bank's access to alternative sources of short-run funding provide assurances that a depositor can withdraw dollar-for-dollar from the bank the principal amount deposited — even when changes in interest rates may have reduced the market value of bank assets.

In the case of the money market mutual fund the ability to pay out dollar-for-dollar the amount of the initial "deposit" is less certain. The fund itself does not have capital as such, and in the short-run it cannot easily tap alternative sources of liquidity to pay out to some shareholders thereby buying time for assets to mature or for interest rates to reverse course. As a related matter, the fund is not insured so that even though the risk of loss to the individual shareholder is small, it does exist. The fact that in recent months a number of money market mutual funds have taken steps in the direction of securing some form of private insurance would suggest that some fund managers perceive that there is an important distinction to be drawn between the fund shares and bank deposits. The irony of this, of course, is that to the extent funds obtain insurance, they come even closer to possessing bank-like characteristics.

To preserve essential bank functions, banks must be able to maintain profitability, attract capital, and hold a de facto monopoly on transaction accounts.

From a competitive viewpoint, the question of whether a money market mutual fund is a bank is far less important today than it was before the introduction of MMDAs at banks. Indeed, if being a "bank" is equated with deposit insurance, access to the Fed's discount window, and payments services — the costs of reserve requirements notwithstanding — some money funds might not object at all to being called a bank in the current market setting. Moreover, if the power of banks or bank holding companies was expanded to permit such institutions to offer mutual funds, the question, from a competitive point of view, would be even less pressing.

However, in terms of intellectual consistency, the question of whether money market mutual funds (or similar arrangements which permit "check" writing) should fall within the definition of a bank does not disappear simply because current competitive conditions render the issue less compelling. On technical grounds, it would seem that the distinction arising from the payment at par principle could justify treating money funds as nonbanks. On functional grounds, however, and particularly from the perspective of the shareholder, the check writing features of some funds simply may create too much of a "look alike" situation to make a meaningful distinction on the technical grounds of payment at par. It may therefore be necessary to place certain restrictions — such as limits on the number of third-party transfers (as with bank-issued MMDAs) and/or reserve requirements — on "nonbank" financial instruments or institutions that provide check writing features. Of course, if MMDAs were defined as transaction accounts, then the case for treating MMMFs as banks would become powerful.

Bank Powers and Structure

If a bank can be satisfactorily defined along the lines suggested above, there are three related questions which must be answered in order to sketch out a reasonable approach to the future scope and structure of banking activities and banks. They are: (1) What kinds of subsidiary powers should banks have? (2) What restraints, if any, should be placed on the ownership or control of banks? (3) Is it important, from a public policy perspective, whether the subsidiary activities of banks are performed in the bank, a subsidiary of the bank, or in a subsidiary of a bank holding company?

Subsidiary banking activities should not entail excessive risk of loss and should not impair the impartiality of the credit decision making process.

The answers to each of these questions must be guided by the earlier discussion of what it is that makes banks special and the relationship between the integrity of the deposit taking function, the financial strength of the bank, and ultimately the strength of the financial system. That discussion implied that in thinking about asset powers, ownership, and the organizational structure of banks, substantial weight needed to be given to safety and soundness considerations, the special trusteeship of banks and the objectivity and impartiality of the credit decision making process. This is not to suggest that other factors such as concentration and public convenience and need are not important from the perspective of public policy. Indeed, these things may be very important, but their importance — in the context of questions relating to banking powers, ownership, and structure — is secondary to the safety and soundness factors.

Having said that, a case can be made that whatever weight safety and soundness and related criteria have been given in the past, these factors should be given less weight in the future. Better information and management systems, more efficient markets, greater disclosure, improved supervision, and the presence of the public safety net, all seem to work in the direction of reducing public policy concerns about the safety and soundness of banks.

However, there are strong forces working in the opposite direction. Financial affairs generally are much more complex and more interdependent than they once were. One consequence of this is that when problems arise they are more difficult to isolate and contain than in the past. Perhaps more importantly, the combination of liability management techniques and deregulation has significantly altered the overall liability structure of banks. Stable and low cost core deposits are virtually a thing of the past. These developments have, in combination with more sophisticated and interest-rate conscious corporate treasurers and individuals, increased the term structure risk at banks and made banks more susceptible to sudden deposit shifts. At the same time, "spread management" — whereby banks attempt to float the rate of return on assets in some reasonably fixed relationship to changes in the cost of funds — may, subtly but insidiously, be working to undermine the traditional disciplines of both borrowers and lenders. Finally, the far-flung international activities of banks have introduced new elements of risk into the equation. While it is a matter of judgment as to whether this crosscurrent of events is working to reduce or to increase the risks associated with the activities of banks, it does seem prudent to conclude that they are working in the direction of creating greater risks.

Bank Subsidiary Powers

As suggested earlier, to preserve and protect the essential functions of banks, banks must be competitively viable institutions. This means, among other things, that banks must be able to offer a sufficiently wide and competitive range of services to maintain profitability, attract capital, and preserve a de facto monopoly on the transaction account business. Without delving into the specific types of powers banks should have, the preceding discussion is suggestive of the general criteria which should be used in making judgments about the scope of banking powers. While a number of factors may be relevant in this regard, the essential functions of banks as described earlier suggest the primacy of two general criteria. They are:

subsidiary banking activities should not entail excessive risk of loss and should not impair the impartiality of the credit decision making process. This dual criteria, while conceptually useful, is operationally ambiguous. To some extent, it becomes more clear in a context in which secondary criteria relating to competition/concentration considerations are introduced. Similarly, as a practical matter, defining the extent of appropriate subsidiary banking powers can be guided by policies governing bank ownership. That is, logic would seem to dictate that a particular set of powers be vested in banks only to the extent that there is a willingness to permit another institution engaging in those activities to own and/or control banks. For example, if we are willing to permit banks to engage in commerce generally (that is, the acquisition, manufacture, or distribution of goods and nonfinancial services), then we should be prepared to say that firms engaged in such business, whether oil companies or shoe stores, can own and control banks. The converse also should follow: if we are unwilling to permit banks to engage in such activities, then logic would seem to dictate that such commercial firms should not own banks. The symmetry of this argument is important, for it lends weight to the apparent consensus that the separation of banking from commerce generally is appropriate and should be maintained in both directions.

A particular set of powers should be vested in banks only if there is a willingness to permit another institution engaging in those activities to own or control banks.

However, even in the realm of so-called financial services, the risk/impartiality criteria do not provide unambiguous insights as to how far banking powers should be extended. For example, if there is a consensus that the risk/impartiality test should not preclude banking organizations from engaging in the sale and distribution of mutual funds shares or in the distribution and brokerage of securities, it is by no means clear that such a consensus would extend to activities relating to the underwriting of stocks and corporate bonds generally or to taking positions in commodities. The point is, of course, that while it is a fairly easy matter to conclude that a continued separation of banking and commerce makes sense, it is not nearly so easy to conclude — as a matter of public policy — that the full range of financial services should be fair game for banking organizations. At the very least, the risk/impartiality criteria suggested above and the bank ownership/control questions discussed below suggest that we should not be indifferent to the scope of financial services offered by banking organizations.

Bank Ownership

If there is some agreement (1) that the segregation of essential banking functions into identifiable classes of institutions makes sense; (2) on the definition of a "bank"; and (3) on the appropriate scope of powers to be housed within banking organizations, then dealing with the question of bank ownership becomes fairly easy. That is, nonbanking organizations would be permitted to own banks only insofar as the activities of such entities match the activities in which banking organizations would otherwise be permitted to engage. For example, a securities firm whose activities did not go beyond the activities directly permissible to banks and bank holding companies could own a bank, but in the process that organization would become a bank holding company. On the other hand, financial or nonfinancial firms could not own a bank unless they were willing to divest those activities which fall outside the list of permissible activities for banks and bank holding companies. Thus, depending on the determination of the scope of banking powers — which, as noted earlier, should be

The holding company structure is neither a substitute for prudent management nor a fail-safe device for containing risk.

undertaken primarily within the context of the risk/impartiality criteria — this approach would require that a number of existing situations involving the ownership of "banks" by financial and nonfinancial firms would have to be grandfathered or, perhaps in some cases, divestiture arrangements would have to be worked out over a period of time.

Banking Structure

Finally, in this context, questions will inevitably arise as to whether it matters, from the perspective of public policy, if particular subsidiary activities of banks are carried out in the bank, in a subsidiary of the bank, or in a subsidiary of the bank's holding company. Given the earlier discussion about the importance of segregating essential banking activities and the importance of the risk/impartiality criteria for purposes of evaluating the appropriate scope of banking activities, it would seem to follow that there is a powerful case for placing some subsidiary activities of banking organizations into affiliates of bank holding companies. This case is reinforced by the protections against self-dealing, which are made possible by certain provisions of the Bank Holding Company Act and by the de facto segregation of capital that is made possible by the holding company structure.

However, it does not follow from the above that we can be indifferent as to the degree of risk associated with such activities simply because they may be housed in a separately organized and separately capitalized subsidiary of a bank holding company. To the contrary, experience suggests rather clearly that in times of peril it may not be possible to insulate the bank from the problems of its sister organizations — even when such problems arise in affiliated organizations, including subsidiaries of bank holding companies. While there are good and sufficient public policy reasons for concluding that at least some "nonbank" activities of banking organizations should be housed in subsidiaries of bank holding companies, such organizational arrangements are not likely to produce a situation in which the bank is immune from the problems, risks, or losses that might develop in such subsidiaries. In short, the holding company structure is neither a substitute for prudent management nor a fail-safe device for containing risk.

In Conclusion

This essay started out with a seemingly straightforward question: Are banks special? Having answered that question in the affirmative, it does seem appropriate that the current debate about the powers and structure of banks be framed in a context that gives greater weight to the underlying issues of what banks are, and what, from the perspective of public policy, we want them to be. Looked at in that light, and with a firmer grasp on what it is that makes banks special, it becomes somewhat easier to grapple with the very difficult questions relating to the definition of a bank, the scope of banking powers, the ownership and control of banks, and the structure of banking organizations. This approach — entailing as it does an element of going back to square one — can help to ensure that bankers, regulators, and legislators approach successive steps in the reshaping of our financial system in a manner which helps to preserve the unique functions and characteristics of banks while at the same time encouraging those elements of competition and innovation that will permit the banking system and the financial system more generally to safely and efficiently meet the needs of a growing and stable domestic and international economy. — ***E. Gerald Corrigan***

Appendix to Annual Report

I. Introduction

This analysis investigates the market shares and relative profitability of commercial banks and other financial intermediaries. It focuses on banks and examines whether they have gained or lost share and how their profits stack up against those of their competitors. The time frame for this investigation is three decades: 1952 through 1981 for most of the data series considered. This relatively long horizon has been chosen intentionally so as to look beyond short-run, business-cycle related perturbations. To go back another decade — to 1942 — might be desirable but would cause problems of interpretation due to financial market distortions during the war years.

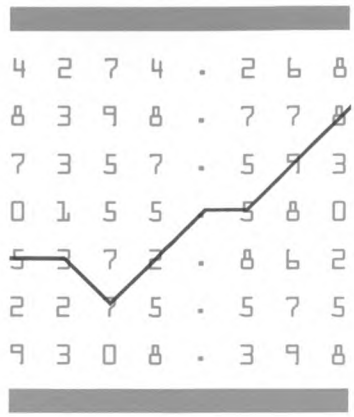
One might ask why this topic is of special interest. The answer is that the commercial banking industry has gone through an enormous amount of change in recent years and has been buffeted by forces from within and without. It is worth studying how the industry has been affected by these events: the ways it has benefited and the ways it has been hurt.

More than a few recent developments have been unambiguously negative for commercial banks — in particular, the increasing presence of nonbank firms in lines of business that were, traditionally, more or less the banks' exclusive domain. Examples of such incursions abound and would include credit card companies, which provide a form of payments service; money market mutual funds, which offer a low-risk savings and transaction vehicle for businesses and consumers; and commercial paper, which is a substitute (often a low cost one) for commercial loans.

Some commentators have focused their attention exclusively on nonbank entry into bank markets, and in so doing they have reached dismaying conclusions as to what has happened (and what is likely to happen) to commercial banks. But this group has cast its net too narrowly, it would seem, because other developments were taking place over the last several decades, too, and some of these were quite favorable for commercial banking.

One example is the legislative and regulatory changes that have permitted banks to broaden their service lines, especially through bank holding companies. Today, bank holding company affiliates are important participants in consumer finance and mortgage banking, something that was not true just a few decades ago. In addition, restrictions on multi-office banking and on deposit interest rates have lost much significance over the last several decades. This is due partly to explicit deregulation and partly to industry innovations that have gone around existing regulations so as to render some of them largely ineffective.

Now, deregulation is not unambiguously good for the banking industry, not even theoretically. On the one hand, deregulation would be expected to increase competition and reduce banks' ability to earn profits in some markets. (It should be remembered that one of the original objectives of Regulation Q and the prohibition of interest on demand deposits was to protect banks from "excessive competition.") On the other hand, deregulation has given banks a freer hand to respond to nonbank competitors' attempted inroads into their markets. In some instances, in fact, it was precisely because of regulation that nonbank firms saw a profit opportunity in bank markets. Money market mutual funds are a case in point. It can be argued that, had commercial banks been permitted to pay market rates of interest all along, money market funds might never have come into existence.



On the basis of these considerations, it seems likely that the last several decades have been a mixed bag for commercial banks, with some developments working to their advantage and others to their disadvantage. The objective of this analysis is to examine the net effect of these developments and attempt to determine if commercial banks have gained or lost — both in terms of market share and in terms of profitability.

Methodology

Market share is measured in a number of ways, using data from several sources including the Flow of Funds and National Income Accounts. There are good reasons for considering a multiplicity of measures and sources. First, each of the data sources is imprecise in one way or another, and each has its own set of biases. Some of these biases are discussed in the following pages, but merely discussing them doesn't make them go away. In light of these biases, a conclusion can be reached more confidently if there is some consistency across a variety of measures.

Moreover, bank markets are, at best, an imprecisely defined concept. In actuality, each commercial bank operates in a variety of distinct markets, which may be defined spatially and by product or service line. (Nor are U.S. banks' markets by any means confined geographically to the United States.) For purposes of this study, commercial banks are treated as a particular class of financial intermediary, and it is assumed that they compete, directly or indirectly, with all other forms of financial intermediation. More precisely, it is assumed that they compete with all other mechanisms for borrowing and lending in the U.S.

With this definition, which is an extremely broad one, it follows that the appropriate market concept is total borrowing (or lending), and that can be measured in a variety of ways — for example, by adding up all debt claims held by lenders or by adding up all financial assets. The market definition is restricted to funds that flow through the United States, ignoring the fact that many U.S. banks truly

compete in a world intermediation market. Although the world market concept might be preferable theoretically, it defies measurement.

The remainder of the study proceeds as follows. Section II presents an analysis of data from the Flow of Funds accounts that are used to measure market share. Section III turns to National Income Accounts data that give information on the size of the banking industry as measured by its total contribution to National Income and some selected components of that contribution — total employment, wages and salaries, and profits. In these sections, five-year moving averages are employed in an attempt to smooth out short-run fluctuations and concentrate attention on long-run trends. Next, Section IV looks at market indicators such as stock market performance and borrowing costs. These measures have nothing to do with market share per se, but they do indicate how investors have viewed the prospects for commercial banks. Finally, Section V provides a summary and conclusions.

II. Flow of Funds Data

Tables 1, 2, and 3 employ data from the Flow of Funds Accounts. Overall, they suggest that banks have maintained their share of total intermediation over the last three decades and in some important submarkets have actually gained market share.

Table 1 shows the percentage of total credit market debt claims against nonfinancial sectors of the economy held by various classes of financial institutions, as well as by nonfinancial lenders such as governmental units, businesses, and households. These series measure, essentially, total lending to the nonfinancial sectors of the economy including the government.

When total lending is measured in this way, commercial banks are observed to have maintained a relatively stable share of about 29 percent over the last three decades. Nonbank savings institutions gained share substantially in the 1950s and the first half of the 1960s, a period when mortgage and housing markets were thriving and economic conditions were favorable for thrifts. After that, their growth flattened.1/ Throughout the sample period, nonfinancial lenders lost market share, reflecting the fact that an increasing proportion of total U.S. credit flowed through intermediaries rather than flowing directly from lender to borrower.

Other evidence suggests that banks' share of total intermediation would be even larger if the analysis were carried beyond domestic boundaries. Commercial banking, as defined in the Flow of Funds Accounts, excludes foreign offices of U.S. banks but includes U.S. offices of foreign banks. The former is several times larger than the latter. Moreover, the Flow of Funds data do not include the nonbank assets of bank holding companies under the banking classification. Rather, they are included in the "Other Financial" and "Nonfinancial" categories in Flow of Funds. If these assets were put in the banking sector total, banks' estimated share of total intermediation would rise by several percent.

Table 2 shows total financial assets of all kinds held by financial intermediaries, a somewhat broader credit aggregate than in Table 1. These assets include holdings of debt claims against nonfinancial sectors (as in Table 1) plus holdings of currency, demand and time deposits, security credit, corporate equities, and member bank reserves. The data in Table 2, therefore, do not net out intermediaries' credits to one another.

According to this measure, commercial banks lost market share until 1967 and, after that, maintained a relatively constant share of around 37 percent. The early loss of bank share went primarily to thrift institutions and to pension funds. During the 1950s and early 1960s, commercial banks were funding a substantial proportion of loan demand by reducing the proportion of financial assets held as cash reserves and as government securities (partly due to reductions in required reserves); thus, they did not aggressively seek new sources of funds. The situation changed in the mid-1960s and later, however, as banks increasingly became aggressive liability managers. Over the entire three-decade period, insurance companies lost share, and pension funds gained.

Table 3 shows data for three specific loan markets important to commercial banks: home mortgages, consumer credit, and business loans. In the home mortgage market, banks lost share until 1965, which was, of course, about when the thrift institutions began experiencing difficulties. After that, commercial banks gained share consistently up to 1982.

Table 1
Shares of Total Credit Market Debt Claims Against Nonfinancial Sectors1/
Five-Year Moving Average2/
1956-1982
Percent

Year-End	Commercial Banks3/	Savings Institutions4/	Insurance and Pension Funds	Other Financial5/	Nonfinancial6/
1956	28.5	11.0	19.6	3.0	37.9
1957	28.0	11.6	20.1	3.2	37.0
1958	27.8	12.3	20.5	3.3	36.1
1959	27.3	12.9	20.8	3.4	35.6
1960	27.0	13.5	21.0	3.5	35.0
1961	26.8	14.1	21.2	3.6	34.3
1962	26.8	14.7	21.2	3.8	33.5
1963	26.8	15.4	21.2	4.0	32.7
1964	27.1	16.0	21.2	4.1	31.6
1965	27.6	16.6	21.1	4.3	30.5
1966	27.9	17.0	21.1	4.4	29.6
1967	28.4	17.2	20.9	4.5	29.0
1968	29.0	17.3	20.7	4.6	28.4
1969	29.3	17.3	20.5	4.7	28.2
1970	29.6	17.2	20.3	4.8	28.1
1971	30.1	17.4	19.8	4.9	27.9
1972	30.5	17.7	19.3	5.1	27.4
1973	31.0	18.1	18.7	5.4	26.8
1974	31.7	18.3	18.2	5.5	26.3
1975	32.0	18.7	17.8	5.5	26.1
1976	32.0	19.0	17.6	5.5	26.0
1977	31.6	19.3	17.6	5.4	26.1
1978	31.1	19.5	17.7	5.4	26.3
1979	30.6	19.7	17.8	5.5	26.5
1980	30.2	19.7	17.9	5.7	26.5
1981	30.0	19.3	18.0	6.3	26.5
19827/	29.7	18.6	18.1	6.9	26.8

1/ Includes government securities, domestic and foreign corporate bonds, mortgages, consumer credit, domestic and foreign open market paper, other domestic and foreign bank loans, and other domestic and foreign debt instruments.

2/ The year shown is the final year in the five-year moving average.

3/ Consists of U.S. chartered banks, domestic bank affiliates, Edge Act corporations, domestic agencies and branches of foreign banks, and banks in U.S. possessions. Does not include nonbank affiliates of bank holding companies or foreign affiliates of U.S. chartered banks.

4/ Consists of savings and loan associations, savings banks, and credit unions.

5/ Consists of finance companies, real estate investment trusts, open-end investment companies, money market funds, and security brokers and dealers.

6/ Includes households, businesses, governments, Federal Reserve Banks, and all foreign entities.

7/ End of third quarter.

Source of basic data: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Assets and Liabilities Outstanding.

1/If the data were expressed in market as opposed to book values, a decline in the savings institutions' share beginning in the late 1970s probably would have been observed.

In consumer lending, banks experienced a spectacular gain in share until 1979, when they had nearly half the market. Since then, their participation has declined a bit. It is probably too soon to say, however, if this downturn in banks' share of consumer lending marks the beginning of a new trend.

Commercial banks also experienced an impressive increase in their share of business lending that continued until 1976, after which it declined. The reversal after 1976 undoubtedly reflects, among other things, the growth of commercial paper as a substitute for bank loans. Nevertheless, it is hard to infer from these data that banks are being crowded out of the business loan market. Their share of that market was substantially higher in 1982, at the end of this period of study, than it was in 1956, at the beginning.

III. National Income Accounts Data

The National Income Accounts indicate the contribution made by each sector of the U.S. economy to Gross National Product (sometimes referred to as the sector's "value-added"). This data source, therefore, reports real economic variables, as opposed to the financial variables reported in Flow of Funds. In this section, such real measures for the commercial banking industry are compared to those for the entire financial intermediary sector.

In the National Income Accounts, the financial intermediary sector is referred to as FIR (Finance, Insurance, and Real Estate). It includes all depository institutions; securities brokers and dealers; life and casualty insurers; real estate brokers, dealers, and agents; and a host of miscellaneous financial institutions. The variables compared include: aggregate wages and salaries, total number of employees, and total contribution to National Income. Foreign operations of banks and other intermediaries are not included in these data. They do include, however, the nonbank affiliates of bank holding companies that are classified under banking.

Turning first to wages and salaries in Table 4, it can be seen that, as a percentage of the FIR total, banks' wages and salary payments have increased very slightly over the sample period — from around 25 per cent to around 27 percent. Their percentage of total employees in the FIR sector increased somewhat faster — from about 24 percent to nearly 30 percent. The difference in trends of these two

Table 2
Shares of Total Financial Assets Held by Financial Institutions[1/]
Five-Year Moving Average[2/]
1956-1982
Percent

Year-End	Commercial Banks[3/]	Savings Institutions[4/]	Insurance Companies	Pension Funds	Other Financial[5/]
1956	45.9	16.1	25.2	6.1	6.7
1957	44.4	16.9	25.1	6.7	7.0
1958	43.0	17.5	24.9	7.3	7.3
1959	41.6	18.2	24.7	7.9	7.6
1960	40.5	18.8	24.4	8.5	7.8
1961	39.4	19.3	24.0	9.1	8.1
1962	38.6	19.8	23.5	9.6	8.4
1963	37.9	20.4	23.1	10.0	8.7
1964	37.4	20.8	22.5	10.4	8.9
1965	37.1	21.2	21.8	10.8	9.1
1966	37.0	21.4	21.3	11.0	9.2
1967	36.9	21.4	20.8	11.5	9.5
1968	37.1	21.1	20.2	11.9	9.8
1969	37.3	20.8	19.8	12.1	10.0
1970	37.5	20.6	19.5	12.4	10.0
1971	37.6	20.6	19.0	12.7	10.1
1972	37.6	20.8	18.6	13.0	10.1
1973	38.0	21.1	18.1	12.9	9.9
1974	38.8	21.6	17.7	12.5	9.6
1975	39.1	22.2	17.3	12.3	9.3
1976	39.2	22.7	17.0	12.1	8.9
1977	39.3	23.4	17.0	11.7	8.6
1978	39.1	23.9	17.0	11.7	8.4
1979	38.3	24.2	17.0	11.9	8.5
1980	37.8	24.2	17.1	12.1	8.9
1981	37.5	23.7	17.0	12.1	9.7
1982[6/]	37.0	23.1	16.9	12.3	10.7

1/ Includes credit market debt claims against nonfinancial sectors (Table 1), plus currency, demand and time deposits, security credit, corporate equities, member bank reserves, and miscellaneous assets.

2/ The year shown is the final year in the five-year moving average.

3/ Consists of U.S. chartered banks, domestic bank affiliates, Edge Act corporations, agencies and branches of foreign banks, and banks in U.S. possessions. Does not include nonbank affiliates of bank holding companies or foreign affiliates of U.S. chartered banks.

4/ Consists of savings and loan associations, savings banks, and credit unions.

5/ Consists of finance companies, real estate investment trusts, open-end investment companies, money market funds, and security brokers and dealers.

6/ End of third quarter.

Source of basic data: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Assets and Liabilities Outstanding.

Table 3
Shares of Home Mortgages, Consumer Credit, and Nonfinancial Business Credit Market Debt Held by Commercial Banks[1/]
Five-Year Moving Average[2/]
1956-1982
Percent

Year-End	Home Mortgages[3/]	Consumer Credit[4/]	Nonfinancial Business Credit Market Debt[5/]
1956	16.1	37.9	38.6
1957	15.4	38.1	38.3
1958	14.9	38.3	38.3
1959	14.4	38.8	39.0
1960	13.8	39.3	38.8
1961	13.2	39.9	38.5
1962	12.8	40.4	38.7
1963	12.4	41.0	39.3
1964	12.2	41.6	39.9
1965	12.2	42.2	41.2
1966	12.3	42.8	42.4
1967	12.5	43.5	43.2
1968	12.7	44.3	43.9
1969	12.9	44.9	44.3
1970	13.0	45.3	44.0
1971	13.0	46.0	43.7
1972	13.2	46.8	43.9
1973	13.5	47.4	44.8
1974	13.9	47.8	45.8
1975	14.1	48.1	46.3
1976	14.3	48.2	46.5
1977	14.5	48.1	46.1
1978	14.7	48.2	45.4
1979	14.9	48.3	44.4
1980	15.2	48.1	44.2
1981	15.4	47.5	44.3
1982[6/]	15.6	46.7	44.2

1/ Consists of U.S. chartered banks, their domestic affiliates, Edge Act corporations, agencies and branches of foreign banks, and banks in U.S. possessions. Does not include nonbank affiliates of bank holding companies or foreign affiliates of U.S. chartered banks.

2/ The year shown is the final year in the five-year moving average.

3/ Consists of home and multifamily residential mortgage loans.

4/ Consists of installment and noninstallment credit.

5/ Includes bonds, commercial and farm mortgage loans, bank business and farm loans, commercial paper, and finance company loans on receivables and inventory.

6/ End of third quarter.

Source of basic data: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Assets and Liabilities Outstanding.

ratios suggests that bank employees' compensation has not increased as rapidly as the compensation of employees of other financial intermediaries, at least not on average.

Either wages and salaries or total employment is a useful indicator of the scale of operations of financial intermediaries except that these measures ignore any changes in capital/labor ratios that may have occurred over time. Unfortunately, there is no simple measure of "output" for financial intermediaries as there is for nonfinancial firms. In fact, financial intermediaries have no sales as such. However, a reasonable proxy measure of intermediaries' output is their total contribution to National Income. This variable measures the total factor costs of services produced by financial intermediaries; it is composed primarily of employees' compensation and profits. According to this broad measure shown in Table 4, the banking industry's percentage of FIR also increased over the full sample period. However, its highest level, 16 percent, was recorded in 1973, and it has decreased somewhat since then.

Profits Comparison

A comparison of profits between industries must be interpreted very cautiously, due to differences in accounting methods, changes in industry composition, and so on. These reservations should be kept in mind when commercial banking's profits are compared with those of other industries.

The banks' share of total FIR profits increased modestly in the 1960s and early 1970s and then declined beginning in the mid-1970s. Banks' share of financial intermediaries' profits followed almost exactly the same pattern.2/ However, the National Income Accounts do not include profits earned abroad, and foreign earnings of commercial banks are probably much more important than those of nonbank financial intermediaries. When the data are adjusted, taking into account the foreign earnings of banks, their share of total financial intermediary profits was nearly flat throughout the 1970s and declined very modestly in 1978 and 1979.

Much more striking than the commercial banks' performance are the broader comparisons of the profit performances of FIR and the financial intermediary firms relative to all domestic corporations. Both the FIR share and the financial intermediary share of total U.S. corporate profits showed marked declines beginning in 1973 or 1974. These declining shares, undoubtedly, reflect to some degree the increased competition in the financial service industries. However, they may also reflect (to some unknown degree) differential effects of inflation on the profits of financial and

Table 4
Bank Share of Finance, Insurance, and Real Estate Firms for Selected Measures of Economic Activity1/2/
Five-Year Moving Average3/
1956-1981
Percent

Year	Wages and Salaries	Employees	National Income4/
1956	25.1	23.9	13.5
1957	25.1	24.1	13.6
1958	25.0	24.2	13.7
1959	24.9	24.4	13.8
1960	25.0	24.7	14.1
1961	25.1	25.0	14.1
1962	25.1	25.3	14.0
1963	25.2	25.5	14.0
1964	25.3	25.8	14.0
1965	25.3	26.0	13.8
1966	25.4	26.1	13.7
1967	25.4	26.3	13.7
1968	25.4	26.5	13.9
1969	25.6	26.9	14.5
1970	25.9	27.4	15.3
1971	26.3	27.8	15.6
1972	26.5	28.2	15.9
1973	26.8	28.6	16.0
1974	27.2	28.9	15.7
1975	27.4	29.3	15.3
1976	27.6	29.5	14.9
1977	27.7	29.7	14.5
1978	27.7	29.8	14.3
1979	27.4	29.7	14.2
1980	27.1	29.7	14.2
1981	26.9	29.7	14.5

1/ "Finance, Insurance, and Real Estate" is a division of the Standard Industrial Classification. It includes banks and other depository institutions; security and commodity brokers and dealers; life,health, fire, and casualty insurance companies, agents, and brokers; real estate operators, developers, and agents; open-end and other investment firms.

2/ Bank component of the "Finance, Insurance, and Real Estate" division includes commercial banks, savings banks, and Federal Reserve Banks.

3/ The year shown is the final year in the five-year moving average.

4/ National income measures the total factor costs of producing FIR services. It primarily includes compensation of employees and business profits.

Source of basic data: United States Department of Commerce/Bureau of Economic Analysis, The National Income and Product Accounts of the United States.

Table 5
Net Income as a Percent of Average Total Assets (ROA) and Average Total Equity (ROE)1/ for Insured Commercial Banks2/
Five-Year Moving Average3/
1956-1981
Percent

Year	Return on Assets	Return on Equity
1956	.59	8.2
1957	.60	8.3
1958	.64	8.6
1959	.63	8.3
1960	.68	8.7
1961	.72	9.1
1962	.74	9.2
1963	.73	9.0
1964	.74	9.2
1965	.72	8.9
1966	.70	8.8
1967	.71	8.9
1968	.71	9.1
1969	.74	9.6
1970	.78	10.2
1971	.81	10.8
1972	.83	11.2
1973	.86	11.6
1974	.85	11.7
1975	.83	11.5
1976	.80	11.3
1977	.77	11.2
1978	.76	11.2
1979	.75	11.5
1980	.76	11.9
1981	.77	12.2

1/ Total equity consists of equity capital and subordinated notes and debentures.

2/ Includes foreign offices of domestic banks. Ratios after 1968 are not strictly comparable to previous years because of changes in income reporting requirements.

3/ The year shown is the final year in the five-year moving average.

Source of basic data: Federal Deposit Insurance Corporation, Annual Reports.

2/Financial intermediaries are a subsector of the FIR sector.This subsector includes commercial and savings banks, Federal Reserve Banks, credit agencies other than banks, and brokers and dealers.

nonfinancial firms, since the last half of the 1970s was generally a period of high and rising inflation.

It is also extremely difficult to compare rates of return in commercial banking with those in any other industry due to the unique nature of the banking business. Bank rates of return on total assets are very low compared to other firms, but this is compensated for by the fact that commercial banks are very highly leveraged. In fact, the only other major industry whose leverage is comparable is securities brokers and dealers.3/

An alternate analytical method, the one adopted here, is to examine the behavior of bank rates of return over time. Table 5 shows the after-tax rate of return on banking industry assets (ROA) and on bank equity (ROE) over the sample period. These data are from the FDIC, not the National Income Accounts, and thus include all bank income, domestic and foreign, but exclude the profits of nonbank affiliates of bank holding companies. The ROA increased secularly until 1973 when it turned down. Nevertheless, the ROA at the end of the sample period in 1981 was substantially higher than it was at the beginning in 1956. This industry ROA trend was determined, of course, by a multiplicity of factors, some positive and some negative. One unambiguously positive factor was that banks increased their reliance on fee income as opposed to interest income. Between 1956 and 1981, fee income of insured commercial banks rose from 11.3 percent of operating income net of interest expense to 19.5 percent.4/ The ROE also rose secularly through the mid-1970s, dipped briefly, and then moved up again so that by 1981 it was at its peak for the past quarter century.

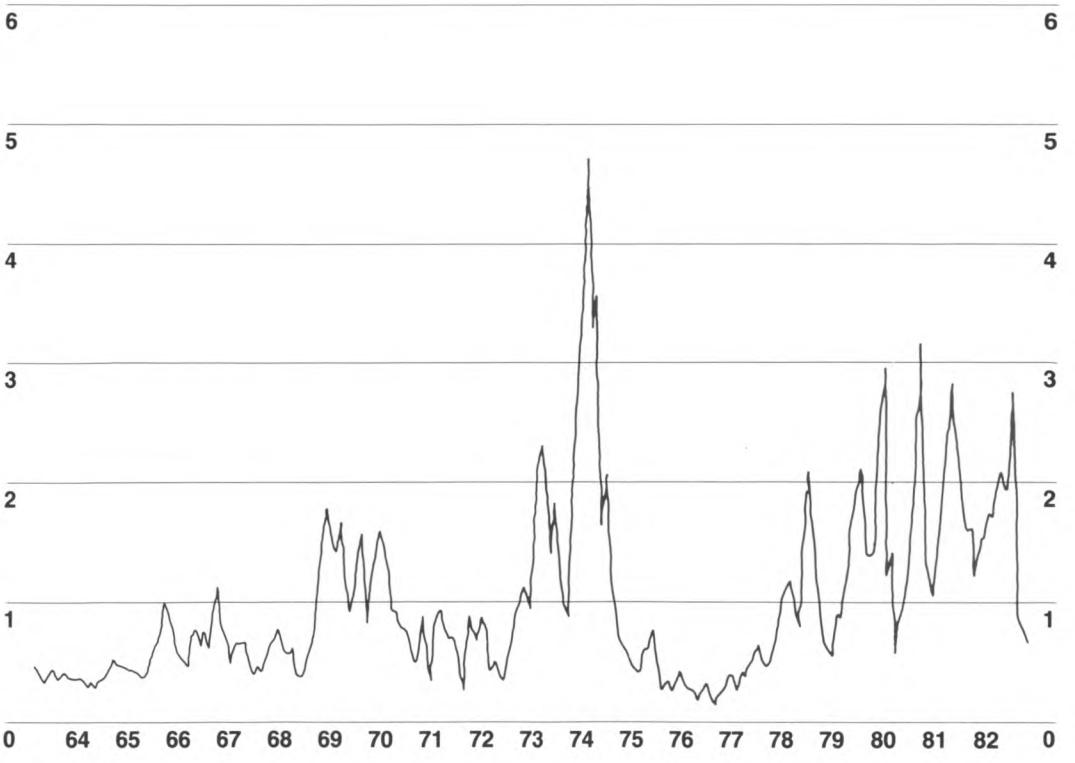
IV. Market Performance

In this section, the market performance of debt and equity securities issued by commercial banks is considered. This analysis has nothing to do with market share or profitability per se, but it is indicative of how securities market participants have viewed the prospects of the banking industry. Since only the largest banks have securities that are actively traded, this analysis pertains specifically to that group.

Turning first to the debt market, Chart 1 shows the spread between rates of interest on large bank certificates of deposit and U.S. Treasury bills of approximately the same maturity. This spread measures the risk premium that banks pay in excess of the risk-free government rate and is a useful indicator of creditors' confidence in the banking industry. The large spike that appears in 1974-75 occurred when the problems of the Franklin National Bank and related financial stresses caused temporary tremors in the debt markets.

Chart 1 indicates that from about 1976 to the middle of 1982 this risk premium rose substantially — approximately 150 basis points. However, this phenomenon was not confined to commercial banks. If a similar risk premium is computed for

Chart 1
Risk Premium on Short-Term Bank Debt
1964: 1-1982: 12
Percent



Note: Data are differences between the three-month Secondary CD rate and the three-month Treasury Bill rate. (Both rates are monthly averages of daily figures.)
Source: Federal Reserve Board

3/The term leverage means the ratio of debt to equity financing. Banks can use more debt financing than other firms due to their access to deposit insurance and the discount window and also due to the regulated nature of the industry. In banking, a more commonly employed leverage measure than debt-to-equity is the ratio of capital to assets (or capital to risk assets).

4/Another factor, mentioned in the preceding discussion of Table 2, is that banks began the sample period in an extremely liquid condition and then consistently reduced proportional holdings of cash and investments (in favor of higher yielding loans) thereafter.

commercial paper issued by nonbank corporations, it follows virtually an identical pattern. What the data seem to suggest, then, is that risk premiums on all private short-term debt have increased substantially since 1976 and, as shown in Chart 1, have become extremely volatile. But commercial bank securities have fared about the same as those issued by nonbank firms.

Turning next to the market for equities, Table 6 shows the performance of several bank stock indices, computed by Standard and Poor's (S&P), compared to the S&P 500 Index, a broad-based measure of stock prices. All three indices have been rescaled so as to equal 100 in 1961, the first sample year. Neither bank stock index performed as well as the S&P 500 over the full sample period, although the New York City banks outgained the S&P 500 over the long subperiod 1961-1976.

These comparisons must be taken cautiously. For one thing, the total return from holding an equity security depends on dividend yields as well as price changes (capital gains and losses), and it is not known if bank equities have exhibited systematically different dividend yields than nonbank equities. For another thing, it seems that various bank stock indices move somewhat differently. For example, a composite index of regional and money center bank stocks, constructed by Goldman Sachs and Company, did about as well as the S&P 500 over the period 1971-1982. So, too, did a composite bank stock index produced by Merrill Lynch. These performances are in contrast to the two S&P bank stock indices in Table 6, both of which performed less well than the S&P 500 over that time interval.

In summary, the risk-premium on short-term bank borrowing seems to have widened in recent years, but so has the risk premium on nonbank private debt. This phenomenon seems to reflect a general shift in lender preferences in favor of quality, not a relative deterioration in the position of bank securities. When bank equity performance is compared with that of the overall stock market, results depend heavily on the choice of indices and also on the choice of end points for the sample period. It is fair to state that over the last 20 years or so, the price performance of commercial bank equities hasn't been radically better — or worse — than that of stocks in general. In recent years though — say, since 1974 — bank stocks may not have done as well as stocks generally. Moreover, it is apparent that bank stocks that once commanded book value or higher are now selling below book values. These recent developments aren't entirely surprising, however, because increased competition in banking would be expected to lead to poorer market performance.

Table 6
New York City Bank, Regional Bank, and Standard & Poor's 500 Stock Indices
Annual Averages
1961-1982
(1961 = 100)

Year	NY City Bank1/	Regional Bank2/	S&P 500
1961	100.0	100.0	100.0
1962	99.9	92.7	94.1
1963	108.8	105.1	105.4
1964	117.3	108.9	122.8
1965	115.2	100.3	133.0
1966	98.6	89.7	128.7
1967	107.7	93.3	138.7
1968	132.4	114.9	148.9
1969	134.5	123.4	147.6
1970	129.7	108.1	125.6
1971	137.2	122.3	148.3
1972	169.8	148.5	164.8
1973	190.8	146.7	162.1
1974	160.4	118.0	125.0
1975	151.9	112.9	130.0
1976	154.2	137.5	153.9
1977	140.0	137.9	148.1
1978	129.3	141.8	144.9
1979	131.7	147.3	155.4
1980	130.0	144.3	179.2
1981	155.2	165.5	193.2
1982	162.1	134.7	180.6

1/ Includes Bankers Trust, Chase, Chemical, Citicorp, Manufacturers Hanover, and Morgan.

2/ Includes Bank America, Continental, First Chicago, First Interstate, First National Boston, InterFirst, First Pennsylvania, Mellon, NCNB, and Northwest Bancorporation.

Source of basic data: Standard and Poor's, The Outlook.

V. Summary and Conclusions

In light of the many and varied developments in commercial banking in recent years, a remarkably stable picture emerges from an analysis of these data. It appears that commercial banks have maintained or even slightly expanded their share of total intermediation, a conclusion supported by analyses of both the Flow of Funds and National Income Accounts. In important submarkets such as mortgage, consumer, and commercial lending, they have gained share over the long run. And bank profits have held up reasonably well, given that many of the markets in which they operate have become increasingly competitive. There is no evidence of a generalized loss of investor confidence in the banking industry, although bank equities may not have performed as well as the overall market in recent years.

It is also true that some of the data suggest a modest deterioration in the banks' position, beginning in about the mid-1970s. But even with this deterioration, the same data indicate that banks were in better condition at the end of the sample period than at the beginning. Thus, these trends may merely reflect a return to conditions consistent with past history.

The data do indicate that, since the early 1970s, profits of financial firms have not kept pace with those of nonfinancial firms, a development that undoubtedly reflects ever-increasing competition in the financial services industries. This is not, in itself, a matter for undue concern as more competition in financial services is probably beneficial to society. And commercial banks have not, apparently, been substantially disadvantaged (or advantaged) in the transition from more to less regulation and less to more competition.

Statement of Condition/In Thousands

As of December 31	1982	1981
Assets		
Gold Certificate Account	$ 154,000	$ 189,000
Interdistrict Settlement Fund	(275,293)	(210,818)
Special Drawing Rights Certificate Account	61,000	48,000
Coin	19,333	16,503
Loans to Depository Institutions	8,500	10,650
Securities:		
Federal Agency Obligations	112,605	136,502
U.S. Government Securities	1,708,669	1,910,771
Total Securities	$ 1,821,274	$ 2,047,273
Cash Items in Process of Collection	687,718	450,834
Premises and Equipment — Less: Depreciation	36,711	34,694
Assets Denominated in Foreign Currencies	213,268	160,736
Other Assets	52,408	45,738
Total Assets	$ 2,778,919	$ 2,792,610
Liabilities		
Federal Reserve Notes, Net	$ 1,758,265	$ 1,463,096
Deposits:		
Depository Institutions	414,348	763,654
Foreign	7,770	10,208
Other Deposits	21,898	2,858
Total Deposits	$ 444,016	$ 776,720
Deferred Availability Cash Items	451,113	420,025
Other Liabilities	27,557	39,083
Total Liabilities	$ 2,680,951	$ 2,698,924
Capital Accounts		
Capital Paid In	$ 48,984	$ 46,843
Surplus	48,984	46,843
Total Capital Accounts	$ 97,968	$ 93,686
Total Liabilities and Capital Accounts	$ 2,778,919	$ 2,792,610

Earnings and Expenses/In Thousands

For the Year Ended December 31	1982	1981
Current Earnings		
Interest on Loans to Depository Institutions	$ 5,720	$ 7,440
Interest on U.S. Government Securities and Federal Agency Obligations	203,166	228,187
Earnings on Foreign Currency	15,911	17,957
Revenue from Priced Services	21,181	9,097
All Other Earnings	277	373
Total Current Earnings	$ 246,255	$ 263,054
Current Expenses		
Salaries and Other Benefits	$ 26,109	$ 23,462
Postage and Expressage	4,999	4,473
Telephone and Telegraph	1,003	846
Printing and Supplies	1,394	1,275
Real Estate Taxes	1,808	1,702
Furniture and Operating Equipment — Rentals, Depreciation, Maintenance	4,410	3,450
Depreciation — Bank Premises	958	852
Utilities	818	639
Other Operating Expenses	3,520	2,716
Federal Reserve Currency	1,631	1,211
Total Current Expenses	$ 46,650	$ 40,626
Less Expenses Reimbursed	2,189	2,022
Net Expenses	$ 44,461	$ 38,604
Current Net Earnings	$ 201,794	$ 224,450
Net Deductions	4,474	11,579
Less:		
Assessment for Expenses of Board of Governors	2,252	2,091
Dividends Paid	2,889	2,737
Payments to U.S. Treasury	190,038	199,274
Transferred to Surplus	$ 2,141	$ 8,769
Surplus Account		
Surplus, January 1	$ 46,843	$ 38,074
Transferred to Surplus — as above	2,141	8,769
Surplus, December 31	$ 48,984	$ 46,843

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Federal Reserve Bank of Minneapolis

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Chairman and
Federal Reserve Agent

John B. Davis, Jr.
Deputy Chairman

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Commercial National Bank
L'Anse, Michigan

Dale W. Fern/1984
President and Chairman
First National Bank
Baldwin, Wisconsin

Curtis W. Kuehn/1985
President
First National Bank
Sioux Falls, South Dakota

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Elected by Member Banks

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Blandin Paper Company
Grand Rapids, Minnesota

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President
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Miles City, Montana

Richard L. Falconer/1985
District Manager
Northwestern Bell
Bismarck, North Dakota

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Appointed by Board of Governors

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Macalester College
St. Paul, Minnesota

William G. Phillips/1984
Chairman and
Chief Executive Officer
International Multifoods
Minneapolis, Minnesota

Sister Generose Gervais/1985
Administrator
Saint Marys Hospital
Rochester, Minnesota

Helena Branch

Gene J. Etchart
Chairman

Ernest B. Corrick
Vice Chairman

Appointed by
Board of Directors
Federal Reserve Bank
of Minneapolis

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President
First State Bank
Malta, Montana

Harry W. Newlon/1984
President
First National Bank
Bozeman, Montana

Seabrook Pates/1984
President and
Chief Executive Officer
Midland Implement
Company, Inc.
Billings, Montana

Appointed
by
Board of Governors

Gene J. Etchart/1983
Past President
Hinsdale Livestock Company
Glasgow, Montana

Ernest B. Corrick/1984
Vice President and
General Manager
Champion International Corp.
Timberlands-Rocky
Mountain Operations
Milltown, Montana

Federal Advisory Council Member

E. Peter Gillette, Jr.
Vice Chairman
Northwest Bancorporation
Minneapolis, Minnesota

Terms expire December 31 of indicated year.

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Thomas E. Gainor
First Vice President

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Senior Vice President
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Senior Vice President

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Senior Vice President
and Chief Financial Officer

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Monetary Adviser

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Assistant Vice President

Helena Branch

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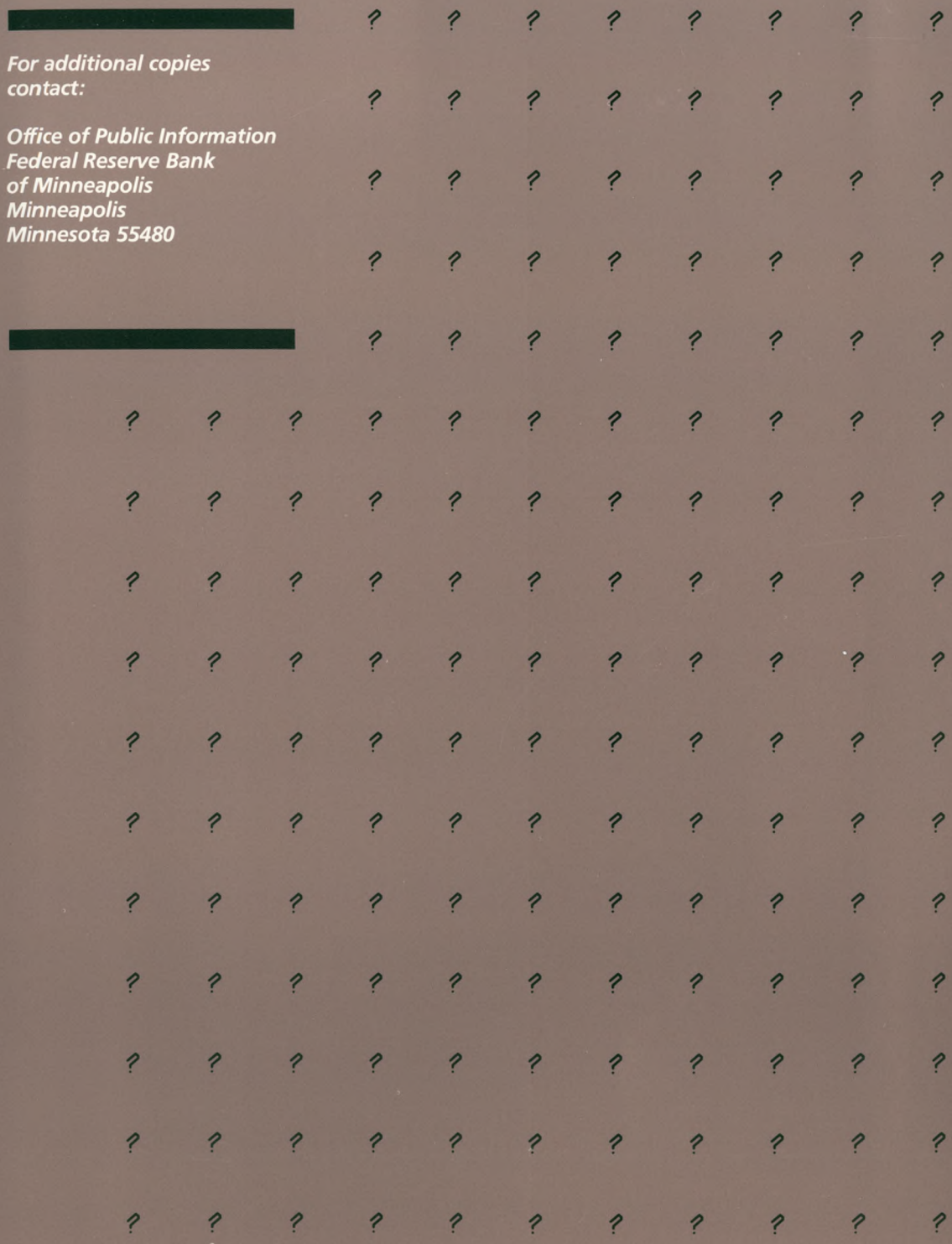
Federal Reserve Bank of Minneapolis



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