Banking in the '80s:

Looking Toward a Constructive Evolution

by

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I think many of you know that over the past 15 to 18 months I have spent a considerable amount of time at meetings like this with banker groups at the local, state, and national level. It's quite natural, of course, that in the process of attending as many meetings as I have, impressions are quickly formed. One such impression that stands out is that there is a lot more serious work being done at these meetings than was once the case. That, I suspect, is both a sign of the times and a sign of things to come.

It is now almost a cliche to say that the banking business is changing, and changing rapidly. The forces for change--whether in the form of technological advances, increased competition from within and outside banking circles, or the proliferation of new instruments--embroil us in what at times seems to be an unstructured and threatening metamorphosis.

The omnibus banking legislation of 1980 is both a response to those forces for change and a catalyst for further change. In that context, I would like to spend a part of the time available to me this morning to share with you some of my tentative thoughts about the longer-run implications of the law.

Before I turn to that subject, however, I do want to say a few words about a subject of more immediate concern to you--Fed pricing. In so doing, I know you will recognize that I am a bit handicapped in that I cannot anticipate what changes in prices and in the approach to pricing will emerge from the Board of Governor's further deliberations of this subject. I might note in passing that the fact that no one seems particularly happy with the Fed's prices--the big banks say the prices are too low and the small banks say they are too high--might mean that the prices are about right. Beyond that general and somewhat facetious impression, I would like to share with you some of my own personal perspectives on several general areas which seem to loom large in the minds of bankers and others.

Perhaps the most important of these relates to the observation--sometimes implicit--that the Fed's approach to pricing is designed to ensure a continued operational presence in all areas of the payments mechanism. In some circles the point has been made that the Fed will even go so far as to use its rule-making authority to guarantee that result. I personally reject both of those views. I would be the first to concede that the payments services provided by the Fed could and indeed should be provided by the private sector if the private sector can in fact provide them in a truly more efficient fashion. Stated differently, I think we should be prepared to lose volume if that is the result of the workings of the market.

Having said that, however, I should hasten to add that there may--and I emphasize may--be a threshold point beyond which that process will not or should not proceed. Let me use extremes to make my point. For example, nobody that I know would argue that the Federal Reserve must provide wrapped coin services. At the other extreme, many--including many prominent private bankers--say that as a practical matter the Fed must provide net settlement services. If that is the black and the white of the spectrum, there are obviously many shades of grey in between. I can't predict which of these shades of grey--if any--will, with the passage of time, appear to be increasingly white or black. But, I can say that the evolution of the payments system and of payment practices in this new environment will require careful vigilance, for what is ultimately at stake is more than the natural and appropriate thirst of banking institutions to enlarge their individual and collective share of the market for payments services. That is, as events unfold, we must ensure that the integrity essential to the functioning of the payments system is preserved regardless of which entities are providing the payments services.

To put it differently, the proposed Fed approach to pricing is not designed or intended to maintain volume levels consistent with existing levels of resources at the Reserve Banks. In fact, it is the other way around. The fee schedule--subject to some technical questions such as the private sector markup where there may be legitimate grounds for some debate and updating of our prices--reflect precisely what the laws require, our direct and indirect costs, plus a markup, for providing priced services. If volume changes over time, the resource base will, and indeed must, be adjusted.

This brings me to the second point I want to comment on in the pricing arena. That is, much of the comment I have seen--including the ABA's own comment--relates to the four pricing principles proposed by the Board over and above those contained in the Act. In retrospect, I will concede there is room for some confusion and misinterpretation in this area. However, at the risk of a further oversimplification, let me say that in a very real sense those four additional principles can be viewed as nothing more than an elaboration of the third principle contained in the Act which makes clear reference to "over the long run," "competitive factors," and "adequate levels of service nationwide." As I see it, basic to the concerns expressed in some of the comments is an underlying belief that the Fed will frustrate competition by somehow "rigging" its prices. Given the fishbowl in which we--unlike you--must operate, and to say nothing of any measure of good faith on our part, I simply don't see how that's possible. At the same time, I don't see why we should not use the flexibility available to us under the law.

Let me again use an example. Suppose a Fed office or the Fed as a whole were to lose 20 percent of its check volume in the first three months of pricing. I do not believe, in that event, that Congress intended for us to immediately fire 20 percent of our check workforce and increase our prices to reflect the spreading of fixed costs over a smaller volume. Nor do I believe that a typical--or even an atypical--private sector firm would respond in that way. That does not mean that adjustments in the Fed's resource base or prices or both will not be made. Rather, that they will be made in an orderly manner consistent with the explicit intent of Congress that we cover our long-run costs.

I don't want to belabor the point. Nor do I want to leave the impression that I think we are faced with an insurmountable problem in developing final rules and prices that are both consistent with the intent of the law and sensitive to the commentary we have received from you and others. Having said that, I must hasten to add that I do not think that a comprehensive "cookbook" can be written at this time that will definitely answer all of your questions. I say that in part because the master chef--in this case the marketplace--will need some time to adjust the recipe as we proceed. Beyond that, I guess I could also observe that "Macy's doesn't tell Gimbels."

Let me now turn my attention to some of the longer-run implications of the Act. As I mentioned earlier, the law may properly be viewed as a reaction to change and a catalyst for further change. It's broad thrust is clear, it is a major move in the direction of banking deregulation which, by definition, also entails the prospect of greater competition in the provision of the full range of banking and banking-related services.

To begin to judge the implications of this new and more intense mode of competition, it is useful to begin with a look at the current "cast of characters" on the banking scene. I'm sure you're familiar with the statistics, but let's quickly review them. There are currently about 15,000 banks, 5,000 savings and loan associations, and 500 mutual savings banks in the United States. In addition, there are about 22,000 credit unions, much smaller in size to be sure, but they also share in some new market powers.

Maybe a better way to think about what's happening is in terms of the number of financial outlets on the street corners. Here, the numbers are even more startling. Indeed, apart from so-called automatic teller outlets, in 1979 there were 52,000 commercial banking offices, 20,000 S&L outlets, 3,500 savings bank offices, and in excess of 22,000 credit union offices. In short, depository institutions had almost 100,000 offices spread around the country. To put that in perspective, there are more banking offices by a factor of one-third than there are franchised fast-food restaurants in the United States.

Of course, it is not fair to look at absolute numbers of banks and banking offices. Many of the financial institutions are highly specialized, either in terms of the market they serve or the services they offer or both. That specialization is in part a reflection of our heritage as a nation and is--or at least was--an important force in structuring the laws and regulations that played such an enormous role in influencing the growth of banking in the United States. For example, there can be no question that part of the rationale for Regulation Q and part of the rationale for the limited asset powers for thrift institutions reflected the high national priority we as a nation have placed in housing. Similarly, intra- and interstate limits on branch banking reflect something of a national political consensus that the credit needs of local communities are best met by local institutions with local management.

Long before the omnibus banking bill of 1980 became reality, market forces had begun to blur some of the historical distinctions between these classes of institutions. Now, with the stroke of a Presidential pen, those market and competitive forces will be unleashed with a new thrust of energy. Nationwide NOW accounts, broadened asset powers for thrifts, and the phase-out of Regulation Q can only work in that direction. Indeed, that is the fundamental premise of the legislation--"let the markets work" and that is a sentiment and a philosophy that we can all embrace.

Because the changes in the new law represent such a major historical turn to market discipline, they carry with them some deeper implications and questions about what this is going to mean over the longer term. These are the kinds of things we should be thinking about from the start and watching very closely as our future experience unfolds. Any time we make major changes in the broad design of our economic institutions, we create a risk that unintended consequences will turn into major new problems. That's the bean-bag syndrome. You push in on an unseemly bulge here and a new bulge appears over there. Yet, the risk of unwanted, costly, and distorting consequences is much the less when the new blueprint moves with, rather than against, the grain of the marketplace.

At least in general, it is not terribly difficult to see the directions in which that grain of the banking environment of the 1980s will take us. For example--

- Small economic units--households and businesses--will have greater opportunities to earn "market-like" interest rates on their cash balances and their savings. This result, while desirable from any number of viewpoints, is particularly welcome in view of the need to raise the level of savings and investment in our economy at large.
- The lifting of Regulation Q should also enhance the competitive position of regulated depository institutions relative to nondepository financial institutions including money market mutual funds.
- The already blurred distinctions between classes of depository institutions will become less evident. Speciali-

zation, I am sure, will continue to be the hallmark of many, if not most, depository institutions, but the degree of that specialization will change.

None of these directions of change seem particularly troublesome on the surface. To the contrary, they can easily be viewed as healthy and constructive developments--symptomatic of the positive benefits associated with the larger role of market forces contemplated in the Banking Act of 1980. But the bean-bag syndrome has its application here too. The evolution we will see is not one that will be without its potential problems. In a very real way, the cutting edge for those potential problems will be the same competitive forces which will produce the benefits we can expect in the new environment. That is, for many institutions, broader asset powers and the need to adjust to a much more competitive environment in which virtually all sources of funding will have an explicit and potentially variable cost will, inevitably, entail more risk.

There are real questions as to how well and how quickly institutions can adapt to these changes, even allowing for the generous phasing-in provisions provided for in the legislation. And even if the adjustments are made with the adroitness that will be required, it does seem likely that some institutions will be facing the prospect of narrowing spreads which could impair the growth in their profitability. Any tendencies in that direction can--and in many instances will--be offset and overcome by the countervailing forces of increased efficiencies via new technology and innovation, improved operations, and improved pricing on both the asset and liability sides of the balance sheet.

However, under any reasonable scenario that I can foresee, I am inclined to the view that at least some degree of consolidation is likely. How fast and how far that process will go is far from clear at this time. In light of this, the dictates of prudence and reason seem to me to imply the need to begin rethinking now some of the "conventional wisdom," some of our regulations, and some of our laws as they might apply to any market-induced tendency toward consolidation of banking institutions. I know that the mere mention of this subject conjures up visions of the hotly contested debate about McFadden and Douglas. And, surely McFadden and Douglas are among the things that we must look at. But we should not lose sight of the need to consider other regulatory impediments to the constructive evolution of our financial structure. For example, in a world of NOW accounts and a blending of lending powers, I have to wonder if the notion that commercial banking is a separate and distinct line of business will be appropriate for the 1980s. Similarly, if we are to cope with a rapidly changing environment, it seems to me that we must take a fresh look at the whole question of economies of scale in banking as they pertain to level and quality of services provided by individual banking institutions. And, as has been observed by the Comptroller of the Currency and others, we must take a new look at our whole regulatory posture, particularly as it applies to smaller banking institutions. I could go on, but you know the agenda better than I. The real point, of course, is that the time to get on with the task is now, not later on when we may be face-to-face with a process of change that has outpaced our ability to respond intelligently and effectively.

In closing, let me also mention one more unsightly bulge that may be emerging on the bean bag. The impact of potential changes in our banking structure and institutions on the conduct of monetary policy could be substantial and troublesome. For one thing, those changes will further complicate the already complex matter of defining and measuring the money supply. We will, for example, witness that phenomenon in significant proportions during 1981 when the introduction of NOW accounts will severely distort the growth patterns of the monetary aggregates. That distortion will, perhaps, be most evident in artifically bloating the measured growth of M1B. But the problem will not end with the NOW account situation. Surely we can anticipate that new instruments, and new banking practices will make it increasingly difficult to be able to single out and measure the things we now call transaction accounts. The new challenges for monetary policy in the banking environment of the 1980s will not be limited to defining and measuring money. For example, as larger fractions of both the asset and liability sides of balance sheets take on floating rate characteristics, and as Regulation Q is phased out, I have to wonder a bit as to where the cutting edge of monetary policy will be.

In short, we are, I suspect, eyeball-to-eyeball with a period of enormous change and challenge in banking and in central banking. One major hallmark of the process of change will be that markets and market forces will play a larger role in shaping our destiny, and regulation will play a smaller role. As I said earlier, that is something we can all welcome, but it is also something we must approach with caution and flexibility. In the process, we will have to adapt our thinking and our institutions in ways that are sensitive to sometimes conflicting or seemingly conflicting objectives. There may be some growing pains associated with the process, and there may even be some problems which we cannot foresee at this time. But I am more than confident that we can, and will, meet the challenges. After all, it has been said that fences are only for those who cannot climb. I know that we can climb.