The Changing Landscape of Banking

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Thank you for inviting me to share some thoughts with you. I have attended these meetings off and on for more than 25 years. Over that time span there have been major changes in the banking landscape.

New Jersey has often been in the forefront of changes in the banking industry. It was one of the first states to adopt statewide branching in 1972. And it was one of the first states to opt for interstate branching after the Riegle-Neal Act was passed in December 1994.

New Jersey has shared in the nationwide trend of bank consolidation. Since 1970, the number of banks in New Jersey has fallen two-thirds, but that doesn't mean the number of bank offices has fallen. In fact, the number of bank offices in New Jersey has increased 75 percent during the past 25 years.

Consolidations have led to increased concentration of New Jersey's banking markets. The share of deposits held by the 10 largest banks more than doubled over the past 25 years, increasing from 40 percent to nearly 85 percent today. New Jersey's banking market is much more concentrated than the nation's.

Competition is also different today from what it was 25 years ago, both on the deposit side and the loan side.

On the deposit side, money market mutual funds and stock and bond funds are competing aggressively with bank deposits.

On the loan side, large corporations started to rely less on banks for short-term loans and more on the commercial paper market. Prime rate lending has never been the same. As time went on, nonbank firms began to compete for middle-market loan customers and even for small-business loans. In addition, banks now have a much larger share of their portfolios in real estate loans, largely because of the declining role of the savings and loan industry in the mortgage market. Banks also have engaged in more off-balance-sheet activities, particularly the securitization of assets.

While financial innovations and new competition changed the banking industry, the regulatory structure also changed dramatically. First came the deregulation of deposit rates. Next came the deregulation of geographic restrictions, culminating this summer with nationwide interstate branching. And finally came greater deregulation of the asset side of banks' balance sheets. Most of this change, however, has come from revisions to bank regulations, not from new legislation. Congress is still considering whether to make major changes to banks' powers.

The focus of the bank regulatory agencies has also changed over the years. The old banking system and regulatory structure were rooted in the technology and legislation of the 1930s, and the primary focus was safety.

Market forces and new technology have broken down this old structure. Now the focus is on risk management. Of course, banks always were in the business of managing risk. What is different now is that the regulatory structure is acknowledging that risk isn't inherently bad, but risk does need to be managed and priced in a prudent manner.

This shift in focus has contributed to further liberalization of the rules under which banks operate. Just recently, for instance, the Federal Reserve completed a comprehensive revision of Regulation Y, which should help banking organizations be more competitive with other financial service providers. The revisions streamline the applications process for both banking and nonbanking activities, remove tying restrictions on bank holding companies and their nonbank subsidiaries, ease requirements for the formation of bank holding companies, and eliminate or modify certain filing requirements under the Change in Bank Control Act.

The shift in focus to the management of risk is also likely to bring further product deregulation in the future. As many of you probably know, I generally favor allowing banks to expand their powers in securities and many aspects of insurance, but have serious reservations about the broad mixing of commerce and banking. Any steps to mix commerce and banking should be small, until we gain more experience with the implications of mixing the two.

An incremental approach is comparable with what was done with securities underwriting. We currently allow banks to affiliate with securities-underwriting firms provided that the holding company is well capitalized and that the securities affiliate derives only 25 percent of its revenue from corporate debt and equity issues. This revenue limitation was originally set at 5 percent, then raised to 10 percent, and late last year was upped to 25 percent as banks (and regulators) gained experience. This type of gradual approach should be applied to any further expansion of banking powers to nonfinancial activities.

For banking to be healthy, we need a healthy economy. And, on this score, I think the near future is quite favorable. The national economy has been expanding steadily for over six years. The unemployment rate has fallen to low levels, and we have continued to experience relatively low inflation. This expansion, which is now beginning its seventh year, is the third longest of the post-World War II era and still going strong.

But some of those pockets are in New Jersey; some parts of South Jersey, in particular, have stubbornly high unemployment. New Jersey has been growing more slowly than the nation throughout this expansion, and the pattern of growth has been uneven. Job levels are still not back to their pre-recession highs, and the state's unemployment rate has been higher than the nation's. Last year, however, New Jersey's job growth did pick up, which is good news.

As I travel around the District, I hear more and more businesspeople say they are having difficulty finding qualified workers. Demand appears to be bumping up against available supply. This sentiment is shared by employers in many other parts of the nation and has raised concern at the policymaking level about the risks of an overheating economy.

The ultimate goal of monetary policy is maximum sustainable growth, and keeping inflation low is important to achieving that goal. If we have learned anything in the past 25 years, it is that low inflation is a plus for sustainable growth and job creation. We cannot buy lasting prosperity by letting inflation creep up. A little upward creep becomes still more creep, and prosperity starts to erode.

To avoid the undermining of growth, it is important to contain inflationary pressures before they take root -- that is, prevention of accelerating inflation is less painful than curing it once it takes hold. Since it takes several quarters for monetary policy actions to have their full effect, policymakers must continuously weigh the risks of waiting too long to resist inflation versus acting too early or unnecessarily. There is a time for patience, as was the case for much of last year and the early part of this year, and there is a time for action. About a month ago the Fed took some preventive action and raised the federal funds rate slightly.

Nonetheless, there are still some yellow, cautionary flags for banks at this stage of the economic expansion. Keep in mind that this is the point in the business cycle when we often get a deterioration in underwriting standards. The economy has been good for a long time, and it is easy to become complacent and think that the good times will last forever.

Bankers, however, should resist this tendency. Don't plant the seeds of future loan problems. These days, people who have been in banking for five or 10 years have limited experience with the performance of loan portfolios during economic downturns. We have had only one recession during the past 15 years. So unless some bankers study history, they may not appreciate what happens when the economy sours. Not that I expect a downturn in the economy this year or next -- I don't. But we haven't repealed the business cycle either, and the profitable loans of today can perform a lot differently under less favorable economic circumstances.

What else is in store for the banking industry? We all expect to see fewer banks in the coming years as industry consolidation continues. But I believe we will still have a large number of community banks for many years to come. I do not expect to see only a handful of super-large banks in this country. In fact, interest in starting new banks continues to be high, although the rate at which new institutions have been opening has moderated. Over the past 10 years, over 1300 new commercial banks have been chartered, 35 of these in New Jersey. At least one new bank opened in New Jersey earlier this year, and one or two others are currently in formation.

Increasing technological change also looms in banking's future, as more electronic forms of banking become widespread. The Federal Reserve and other bank regulators are trying to avoid imposing regulatory constraints that might stifle innovations in the development of electronic forms of payment, such as stored-value cards. It is too early to know how electronic forms of money might evolve, and we do not want to inadvertently stand in the way of innovation.

Nonbank competition also will remain heavy in future years, even without new legislation that could further erode the barriers between types of financial institutions. Changes in technology and delivery systems are simply making it easier for all types of financial firms to compete on what has traditionally been banks' turf.

I expect to see more attempts by nonbanks to become more directly involved in the payments system, which historically has been the sole province of the banking industry. For example, nonbanks now own a significant percentage of ATMs, from which depositors gain access to their bank accounts. And nonbanks play significant roles in providing electronic interfaces that consumers can use to initiate payments. For example, Intuit and Microsoft offer software for PC banking. Also, nonbank-sponsored credit cards are increasingly competitive with bank cards.

With a changing environment, we in the Federal Reserve must also ask what changes we need to make. For instance, we are now putting more emphasis on risk management within our own organization. At the System level, we have combined discount window issues and payment-system-risk issues with other risk-management issues, placing all of them under the purview of one committee. Many Reserve Banks, including Philadelphia, are in the process of realigning their internal functions to match this System focus on risk management.

The Federal Reserve has also consolidated some of its operations. We consolidated our computer operations several years ago -- from 12 sites to three. And we consolidated our savings bond operations into regional centers. We also established Product Offices, which coordinate some of the priced services as well as the cash and fiscal services offered by the Reserve Banks. Like you, we are searching for ways to achieve greater efficiencies.

We are also asking whether the product lines we are in are the right ones for the future. To help answer that question, we have established a special, high-level committee to examine the Fed's role in the retail payments system. This group, headed by Vice Chair Alice Rivlin, will hold nationwide meetings to get industry and consumer feedback on some alternative scenarios depicting possible roles for the Fed in the retail payments system.

At the other extreme, the Fed would become more heavily involved in retail payments services by quickly and deliberately moving the nation toward an electronic-based retail payments system. This other extreme would involve the Fed more deeply in facilitating the adoption of technologies and industry standards for electronic payments. The intent would be to make these electronic payment systems as universally accessible to all banks as the current paper-based system. The Rivlin Committee is also looking at two middle-ground scenarios that would have the Fed continuing to participate, as we do now, in providing retail payment services to varying degrees.

This exercise of assessing the Fed's role in retail payments forces us all to reevaluate ways in which the Fed and other payments system participants interact. For example, were the Fed to liquidate its check-processing operations, obviously many banks around the country would have to turn to correspondent banks or clearing houses to process retail payments. At the other extreme, if the Fed became more involved in pushing the development of electronic retail payments, it might offer, for example, opportunities for banks to piggyback on the Fed's campaigns to enlist customers in direct-deposit programs and other uses of the ACH. Reevaluating the Fed's role is healthy, and our success will depend on the comments received from banks and others with an interest in an efficient, dependable, and accessible payments system.

This fundamental look at the role of the Fed in the payments system is a topic you will be hearing more about in coming months. Several national forums will be held in various locations in May and June to hear from stakeholders, especially banks -- both large banks and community banks. In addition, each Reserve Bank will hold district meetings with bankers and other stakeholders to get their views.

Since retail payments such as checks are fundamental to the business of banking, you should think carefully about what the Rivlin Committee is doing and what the implications might be for you and your customers. I urge you to offer your comments about whether the Fed should remain in the payments business or whether the Fed should get out. Even if you do not currently use Fed services, your views are important. For example, many community bankers, even those who do not use our payments services, have told me they think having the option to use the Fed for processing retail payments is valuable. I assure you that your comments will be heard.

To conclude, the banking industry will continue to undergo fundamental changes in the coming years. We all need to adapt and try to make change an opportunity, not just a challenge. Whatever change might bring, however, our

fundamental goals remain constant: a stable and healthy financial system; a noninflationary economic environment that supports the maximum sustainable growth of output and jobs; and a stable, efficient payments system accessible to banks of all sizes.

Each scenario explores what would happen to the future environment for financial services if the Fed took a particular role as a provider of payments services. At one extreme, the Federal Reserve would liquidate its retail payments operations and no longer provide retail payments services to banks -- neither check services nor ACH. A second scenario involves privatizing the Fed's retail payments operations by spinning them off into what would become an independent entity.

Increased competition in providing payments services could lead to greater efficiency in the industry and may yield benefits to consumers. But the expansion by nonbanks into some segments of the payments system also raises a number of issues. One is whether further expanding the involvement of nonbanks in the payments system can be done without also expanding the scope of the federal safety net. Related issues involve how the participation of nonbanks in the payments system might affect its stability, as well as its efficiency and accessibility. And a final issue is whether expanding access to nonbanks can occur while maintaining a level playing field with banks providing payments system services. All these issues will need closer examination as the barriers between banks and nonbanks continue to erode in the payments system.

As time goes on, we will have to make additional judgments about where the risks lie. Preventive medicine isn't always popular, but it almost always pays off. In 1994, when interest rates were raised to avoid overheating, we were successful in prolonging the expansion and job creation through preemptive action. I think we have a good chance to do the same in 1997.

In the Philadelphia Fed's District, which includes much of New Jersey and Pennsylvania as well as all of Delaware, almost all segments of the economy are expanding, and people seem confident that expansion will continue through 1997 and 1998. The District's economy is generally operating at a high level, with only some pockets of weakness.