FINANCIAL INSTITUTIONS IN A CHANGING ENVIRONMENT

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It is a distinct pleasure to be with you today in observance of the 150th anniversary of the savings bank movement in this country. It was in 1816 -- the morning of December 2, to be exact -- that Mr. Curtis Roberts of Philadelphia walked into the office of the Philadelphia Savings Fund Society and became the first depositor at a mutual savings bank. Mr. Roberts left $5 with PSFS. At the end of the day, the new institution had accumulated a total of $25 in deposits.

Today, deposits at mutual savings banks total more than $53 billion. If Mr. Roberts and the Reverend Duncan could be with us today, they would be astounded to learn that savings banks now number over 500 with some 1,200 offices serving depositors who hold more than 22 million savings accounts. They would no doubt be pleased to find that savings banks hold the mortgages of 3 million families and that $8 billion in new mortgage loans were made last year alone.

Mr. Roberts and the Reverend Duncan probably would nod approvingly as well (if they could be coaxed away from the marvel of television and granulated detergents) at the aggressiveness of the 150-year old savings bank industry, an aggressiveness highlighted this year by the quest for federal chartering and the power to make consumer-type loans.

Today, in your sesquicentennial year, I should like to look both backward and forward with you. I should like to discuss some of the factors important in both the past and present evolution of savings banks and financial institutions in general.

This may seem at first blush a bit "far out" to you at a time when we all face complex and pressing problems every day. Interest rates, deposit flows, employee turnover -- these and countless other factors occupy much of our time and energies. However, before I am finished, I hope to be able to suggest some important implications for you in taking such a broad view.
First, let me sketch briefly the broad factors important in the growth of savings banks and other financial institutions.

It is not difficult to see why financial institutions developed and prospered in the United States, a nation with great industrial potential, bountiful natural resources, and an expanding population. As our nation grew we needed funds to finance business and agriculture. We needed mortgage money and depositories for our savings.

To meet our growing financial requirements, the following alternatives were possible:

1. Existing financial institutions could expand their operations to encompass new needs, or
2. Additional institutions could be established as financial demands evolved.

In fact, existing institutions were either reluctant to meet or unable to satisfy fully our dynamic demand for financial services. As a result, new institutions were established as new needs became more evident. But let us turn back the pages of time and see for ourselves.

Our first financial institutions, of course, were commercial banks. The first chartered bank in our young country appeared in 1781. By 1834, we had 500 banks. By 1861, we had 1,600.

Banks developed in response to increasing demands for hand-to-hand currency and a need for commercial and agricultural credit. They met both of these needs by lending their own personal bank notes to merchants and others. The loan transaction provided credit. The borrower put the notes into circulation in payment of his own obligations, thereby increasing the supply of currency. Later, of course, commercial banks went heavily into the demand deposit business.
But the early banks did not provide nearly the range of services that banks do today. Bankers felt, first of all, that the nature of their liabilities prohibited them from making either long-term business loans or housing loans. Since their deposits and bank notes were payable in gold on demand, and since only a fractional gold reserve was held against these liabilities, they reasoned that their credit activities should be limited to short-term loans of 30- to 60-day maturity. Such loans, they believed, would insure a continuous inflow of funds and thus easily enable them to meet their demand liabilities.

Nor did bankers concern themselves with consumer lending. To lend for consumption purposes, they felt, was to violate the very principle on which banking was built -- thrift. Finally, and in spite of their emphasis on thrift, bankers made no provision for interest-paying time deposits.

We can see, then, that a number of voids were evident in our growing economy -- voids destined to be filled, if not by bankers, then by someone else.

Rising incomes in the United States and the expansion of urban population helped emphasize one of our first and most pressing financial voids. Early in the nineteenth century more people began to accumulate savings. Most individual savings, however, were not large enough to justify the purchase of stocks or bonds. Some alternative outlet was needed, one which would be safe, liquid, and yield some interest.

At the same time an acute housing shortage was developing on our Eastern Seaboard. Immigration from abroad had begun to swell Philadelphia, Boston, New York, and other cities. Expanded housing facilities were urgently needed.

Public-spirited men began to ponder these problems. They concluded that institutions should be set up to encourage thrift by accepting interest-paying deposits. And what, they asked, would be more reasonable than to invest these funds in mortgages?
The result was the mutual savings bank. The nation's first mutual, as already noted, was opened in Philadelphia in 1816. In the same year, a second was chartered in Boston. But the demand for mortgage credit grew faster than the mutual savings bank. In 1831, another type of institution was established, the savings and loan association. The savings and loan association, served the same function as the mutual, accumulating savings and making mortgage loans.

Along with the growing demand for mortgage funds, an increasing flow of long-term business capital was required as we built new factories, expanded our railroads, and as we pressed westward toward the Pacific.

Fortunately, the rising demand for capital funds coincided with a second developing economic need. People in the United States were becoming security-conscious. With our rising incomes, we had begun to think not only of the present but also of the future. We became willing to part with a portion of our present income to assure our future economic well-being. In short, we became interested in insurance.

The need for security thus gave rise to a new and important source of funds. And this particular source was peculiarly suited to long-term uses. Unlike bank deposits, insurance-type payments were more regularly received and less likely to be withdrawn. Moreover, it was found that current claims could generally be met from current receipts. Thus liquidity was less of a problem. Funds channeled into insurance-type institutions could be committed for the long term, to finance our burgeoning industrial expansion and to meet further housing needs.

Given the needs, the insurance-type institutions began to appear. Fire, casualty, marine, and then life insurance companies were first on the scene, followed by trust companies, private pension funds, and much later,
investment companies. Some, including the insurance companies, had prototypes in operation even before the signing of the Declaration of Independence. But the real period of development and expansion came after 1850, with the unprecedented expansion in industrial activity and real incomes.

But not all of our rising incomes were paid into trust funds, savings deposits, or insurance premiums. Between 1850 and 1900, the United States economy was gradually assuming the high-consumption personality that so well characterizes it today. Who could resist the gaily painted bicycles pouring off our production lines? What young housewife could forego that wonderful invention, the sewing machine? Consumer sales soared.

And rising sales of consumer goods were accompanied by an expanding demand for consumer credit. Characteristically, however, existing institutions were reluctant to enter this new and unexplored field. They looked at the consumer down the length of their collective noses. Where credit was extended, it was usually the seller of goods who obliged.

This situation, however, was to be short-lived. Some of the first institutions specializing in consumer credit were the prototype personal finance companies which began to appear in the 1870's. They were followed by credit unions in the early 1900's. At first, these institutions lent not to facilitate the purchase of specific consumer goods but to tide the borrower over some temporary emergency that had arisen in his life.

Later, in the twentieth century, personal finance companies and credit unions finally became important sources of credit for specific durable consumption. Then, along with their new competitors, the sales finance companies, they were quick to respond to the wails of the infant which was to become the giant of American industry, the automobile.
In 1900 there were about 8,000 automobiles in the United States. By 1917 almost 2 million units a year were sold. And with the automobile came radios, washing machines, refrigerators, toasters, etc., etc. The modern period of consumer credit had begun. Where consumption loans had been calculated in millions of dollars, they were now expressed in billions! Consumers had become the backbone of big business.

All of these developments did not escape the eye of the commercial banker. He saw the growing demand for housing, for business capital, and for consumer credit. And he was not unaware of the profits which accrued to the specialized financing institutions. But throughout the nineteenth century and part of the twentieth, the demands for his traditional ware -- short-term commercial credit -- were generally adequate to absorb most of his funds and thus keep him in an orthodox frame of mind.

Let his traditional demands become inadequate though, and the banker might prove less orthodox than many suspected. Indeed, he might reverse the entire trend of the development of financial institutions in the United States. Rather than specialization, he might usher in a new era of diversification in financial services.

In the 1930's, after the first financial shocks of the great depression were spent, we had the first real test of the banker's orthodox preference for short-term lending, for his excess reserves skyrocketed while commercial loans became scarce.

With surplus funds, the banker began to cast about for additional borrowers. In his quest, he noticed certain structural changes that had developed in our economy -- changes which might help him bridge the yawning gap between short- and long-term lending. The Federal Reserve System gave him a source of credit on which he could draw in case a liquidity crisis
should arise. The growth of commercial bank time deposits provided funds less subject to sporadic and sudden withdrawal. The introduction of Government-insured mortgages and of a secondary mortgage market added to the safety and liquidity of mortgage lending.

The structural changes plus the existence of surplus funds turned the trick. Mortgage loans, long a staple of the rural banker, became a much more significant portion of the urban banker's loan portfolio. The banker became ever more willing to make long-term loans to business. And, noticing that the sales finance companies didn't "go under" during the depression as he had expected, the banker began lending on a larger scale to consumers. The age of specialization had indeed given way to the age of diversification. The structure of our financial institutions was changing toward its present-day form.

The point of this brief chronology, is that a changing environment has called forth the development of new institutions to meet new needs. Therefore, the first phase of development was the creation of a variety of specialized financial institutions.

Then came a second phase, one in which the specialized institutions saw green grass in the other fellow's back yard. In a very general sense -- and like all analogies, this should not be pressed too far -- the development of financial institutions has been similar to biological evolution. The simple organism which washed ashore somewhere eons ago, found a new environment and adapted. As it adapted and developed, it became an increasingly complex being. Similarly, financial institutions, originally more like single-celled entities, have become more complex as they have adapted to a changing environment in order to survive.
Let me emphasize, however, that today's financial manager is not a passive pawn of his environment. He acts as well as reacts. You and other leaders in the financial sector cause change. You help shape economic conditions, financial markets, statutory and regulatory provisions, and social attitudes just as your development is affected by these factors. Much of the impetus for change lies with financial institutions themselves.

An example of the fate awaiting those financial institutions which fail to adapt or are unable to adapt to a changing environment is found in the postal savings system. Several weeks ago the President signed a bill which abolished the system. Although it was a competitor of mutual savings banks, you had little cause for joy at its demise. The postal savings system was in fact an obsolete competitor. It had outlived its purpose, so Congress killed it. Had the system over the years been able to adapt, to find new purposes, to compete vigorously, it would not have shriveled up or have been cast away.

I should like to look briefly at some of the principal arenas in which this dynamic process of adaptation and competition is taking place at the present. After this I shall attempt to define the environmental factors responsible for the present flux.

As for the arenas, financial institutions -- as you well know -- are slugging it out in markets which range all the way from consumer loans to mortgages and from savings deposits to business financing.

In the mortgage markets, the old competitors are hard at it. In an effort to compete more effectively, mutual savings banks are engaged in a well-publicized struggle to secure federal chartering, thus opening new geographical frontiers for expansion. As you well know, one problem is that mutual savings
banks have been missing out on much of the cream of residential mortgage demand which occurred in the Southwest and West -- areas not served by savings banks. The extent of the competition for mortgages is well illustrated by the fact that, since 1960, commercial banks have increased their mortgage holdings by 71 percent.

In the consumer lending field, efforts are underway by organizations of savings banks and savings and loan associations to secure statutory and regulatory permission to make consumer loans. Moreover, life insurance companies are making more loans against cash value of policies and thereby competing in the consumer loan market as well as in the real estate mortgage market. Indeed, loans to holders of life policies are no minor item; they stood at 4.8 per cent of total life insurance company assets at the end of 1965.

Life insurance is not sacrosanct either. Mutual savings banks in New York, Massachusetts, and Connecticut have long been active in the field, and creation of the Savings Bank Life Insurance Co. of Connecticut has made possible the extension of SBLI to other states as well.

And the changes which are occurring are not limited to the asset side of the balance sheet. Competition for deposits is intense. Commercial banks, which had found themselves trying to finance longer-term assets with liabilities payable on demand, have found it necessary to rely more on longer-term liabilities. But they could not compete effectively with savings banks and savings and loan associations which had access to longer-term deposits by paying higher rates of interest. The revolutionary changes in commercial banks' scope of operations justified more intense competition for deposits. Innovations were made in savings and time deposit accounts and new terminology was employed in bank advertising and the so-called savings race was on. The new competition for savings is now a fact -- a sometimes painful fact -- of life for all financial institutions.
Other areas of intense competition are evident in the struggle between savings and commercial banks. Mutual savings banks today scarcely resemble those of a few decades ago. They now compete with commercial banks in offering safe deposit facilities, selling traveler's checks, and providing collection facilities for depositors. Savings banks as yet do not accept demand deposits; but savings are paid virtually on demand and a depositor can draw a money order against his account. Other dramatic changes among financial institutions have occurred in recent years, with the result that mutual savings banks, savings and loan associations, and commercial banks are just not so different now as they once were.

All these examples point out this second kind of adaptation. Financial institutions are encroaching upon each other's areas of operation. The growing complexity and blurring distinctions among institutions in our increasingly complex society is completely natural. We note it in other areas of society. The sciences no longer can be divided simply into such branches of learning as chemistry, biology, astronomy, physics, and the like. We now have bio-chemistry and astrophysics, for example. Even the old familiar classifications of industry are increasingly meaningless.

It seems to me there are at least two very basic environmental reasons for current competition among financial institutions. One has to do with the desire of the various institutions to isolate themselves from the effects of contracting or confining specialized markets. The other concerns the modified attitude of many regulatory authorities.

As for markets, I think managers of financial institutions are aware that in a rapidly changing economy their area of specialization may not always continue to grow adequately. For example, after two decades or so of rather feverish activity, the housing market has turned soft in many areas of the country in recent
months. The fact is that multi-celled institutions may be better able to adapt to changes in the environment than their uni-celled counterparts. Damage to a single cell poses less danger to the whole institution. Security, stability and growth require a more complex structure. Therefore, financial institutions became more complex through diversification into new areas and expansion of their base of operations.

A second cause of institutional change is a modified attitude of many regulatory authorities. As the bitter memories of the early 1930's fade (and as public policies have evolved to help insulate the economy from convulsive disruptions), authorities have become more receptive to innovation.

We have witnessed broad expansion in the powers of commercial banks in recent years which has enabled them to compete more vigorously with many types of nonbank institutions. And as each of these institutions finds itself competing with commercial banks on home territory, it seeks regulatory permission to counter-attack in an area which had previously been the private domain of commercial banks. We have a domino effect which soon has affected many different types of institutions.

We have seen how several types of financial institutions have, under present-day supervision of the regulatory authorities, adapted to change and how the lines of demarcation between institutions and markets have become blurred. All of this adds up to increased competition.

Is increased competition among financial institutions desirable? This is a crucial question. And it is one which is more difficult to answer than appears at first glance.

Certainly one of the most desirable social effects of increased competition is that the public is given more options in selecting the most favorable benefits from its relationships with financial institutions. A prospective homeowner has more financing alternatives where mutual savings banks, commercial banks, and savings and loan associations compete. Similarly, an automobile buyer has
more options if he can look to several types of institutions for financing. Furthermore, we may expect individual institutions to be able to operate more efficiently through the flexibility provided by a broader base of operations. These factors should yield better service at less cost to people seeking satisfaction of a broad array of needs.

There is, however, an aspect of increased competition among financial institutions which may carry a substantial social cost. When financial institutions bid vigorously for the opportunity to lend money, credit standards may be forced downward. Where reduced yields on high-quality loans result from increased competition, management may seek to compensate by securing higher yields on lower quality loans. Assumption of excessive risks, however, may weaken the entire financial system. The dangers as well as the real opportunities emphasize the vital importance of high-quality professional management for financial institutions.

Certainly we cannot allow competition among financial institutions to approach Spencer's notion of survival of the fittest. Society long since has acted to modify the harshness of this philosophy. Regulation of financial institutions is desirable to protect the institutions and the public as well.

But regulation should not be brandished as a shield against competition. The health of society depends on a balance of the two forces of regulation and competition.

Moreover, it should be noted that, if financial institutions desire to play in the same ball park -- compete for the same depositors and for the same financial assets -- it is only equitable that they be subject insofar as possible to the same set of rules. Laws and regulations, unless uniform, confer undue advantage.

At present many institutions possess special advantages. These range from various forms of tax advantage to privileged concessions such as the
ability to underwrite municipal bonds and deal in United States Government securities. If financial institutions are to compete more across the board, then that competition must be fair and equitable.

In short, the problem of financial institutions and authorities today is to foster innovation, to nourish adaptation, to promote flexibility -- all while maintaining a sufficient degree of safety -- so that the financial sector is best able to serve society in an ever-changing environment. Your concern and mine is that each change, innovation, and adaptation is aimed at maximizing the vigor, flexibility and safety of the financial system so that it best meets the needs of a changing economy.