

BANKING PROBLEMS AND OPPORTUNITIES

Remarks by

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I am happy to congratulate you on completing a rigorous course in the theory and practice of modern banking. Professional schools such as the PCBS play a key role in preparing bankers to take on expanded responsibilities in an increasingly complex business and social environment. Having had a long association with commercial banking before returning to the Federal Reserve System, I'm familiar with the pressures you are facing today, but I also see many of the opportunities opening up for you in the future.

Graduation speakers generally are like football coaches before the opening game of the season. They speak in glittering generalities of the tasks ahead, knowing full well that their untested charges will learn on the gridiron that the game contains not only some thrilling moments but also some dull routine and unexpected disasters. I see my assignment somewhat differently, that is, to speak as the coach at midseason rather than on opening day. You have already been blindsided, mouse-trapped and cited for illegal holding, perhaps many times, so you know what the game is all about. In fact, you have already found ways of overcoming many of the banking industry's problems and of breathing life into its myriad opportunities. Perhaps the best I can do is to alert you to some future problems which, through your skillful ballhandling, you can transform into touchdown spectaculars in your future careers.

Let's begin by examining some of the technical and legislative developments that will affect banking in the final quarter of the twentieth century. The banking industry is changing in character.

It is offering new types of services as well as a wider range of services. While diversifying and introducing new technology, banking is also facing growing competition from many other types of financial institutions. It will be your task as managers to adapt to these new conditions and pressures.

New Opportunities Through Holding Companies

As you know, the 1970 amendments to the Bank Holding Company Act have opened up several new prospects for banks. First, banking organizations can expand into related fields and, second, through holding companies they can break through the state-boundary limitations that now constrain commercial banks.

The Federal Reserve Board of Governors has approved twelve general activities which meet the legal standard of being closely related to banking. Among the more important are mortgage banking, consumer finance, leasing and data processing. This laundry list of approved activities, I want to emphasize, is still in flux and more categories may well be added. All of this means that banks have gained the flexibility to develop new financial services and to create diversified financial enterprises.

The right to expand across state lines is the key that truly opens the door to growth. Without this power, holding companies would have similar powers to those now available to commercial banks or their subsidiaries. Interstate operations create the possibility of building efficient-sized organizations. Interstate operations also generate the possibility of increased competition that was the ultimate public policy justification for the change in the Bank

Holding Company Act. The lesson for all banks, large and small alike, is that they must look beyond the practices of traditional commercial banking and the boundaries of local markets. Failure to do so might result in missed opportunities for growth and in increased competition from unexpected sources.

Now let me add a bit of advice: don't abandon your traditional attitude of prudence, even while pursuing new opportunities. Conservatism used to be the hallmark of the banker. The conservative banker may be a stock character in comedy routines, but we could have used many more of them at Franklin and U.S. National and other places in the past several years. Without due prudence, an organization can over-expand, straining both its managerial resources and its financial strength.

The Competitive Challenge from Nonbanks

The thrift industry, like the banking industry, faces many new challenges, and its response will impinge on your own operations. The thrifts have been hampered by their ties to the sometimes shaky housing industry and by their reliance upon passbook savings for funds. I think this situation is changing, so that you should be prepared for a new set of financial challenges.

As you know, the President's Commission on Financial Structure and Regulation--the Hunt Commission--recommended that thrift institutions be given broadened lending and investment powers, and even more important, given the authority to make third-party transfers. To this point, Congress has not approved the legislative package approved by the Commission, and to some extent, seems to be shifting away from the liberalizing spirit of the Hunt proposals in favor of more constraints over interest rates

and loan portfolios. A case in point is the current proposal by some Congressmen to allocate credit to housing and other "priority" sectors, and to reduce the flow of funds to "nonpriority" uses. The legislative prospect now seems to be for a piecemeal approach to the many issues involving reform and revitalization of the nation's financial institutions. If recent history is any guide, the thrift institutions may wind up with new powers, without losing all of their present advantages or being subjected to the constraints imposed on their banking competitors.

In addition, regulatory agencies have already added to the powers of the thrift institutions, especially by clearing the way to electronic payments services for S&L customers. The Federal Home Loan Bank Board recently adopted a regulation permitting Federal savings and loan associations to utilize RSU's--remote service units or electronic tellers. These machines, which are activated by plastic cards, perform such functions as paying and receiving funds and receiving loan payments. Significantly, the regulation permits a Federal S&L to establish RSU's anywhere in the state where its home office is located, and anywhere in the primary service area of an out-of-state branch. If the thrift institutions were to adapt RSU's to accommodate third-party payments, they would be on the threshold of a full electronic payments system, thereby bypassing the bank check as a means of payment.

The point is, bank managers in the years ahead cannot expect to be bankers in the traditional manner, or they will be outflanked by increased competition from other banks and nonbank financial

institutions. To be viable competitors, managers must look to new ways of doing business; they must build better mousetraps.

Technology and Finance

Although I have just discussed banking's future in terms of increased competition, I should emphasize that what we are really witnessing is the impact of technology on banking's way of doing business. An electronic payments system is on the way, and its techniques can be mastered as readily by thrift institutions as by banks. Technology thus is the force behind the new competition that I've described.

The Hunt Commission's recommendations anticipate a world in which remote facilities link customers not only to their own accounts, but to other accounts as well. Legislative and regulatory changes are bound to occur--as they already have--in response to new techniques. But today's banking structure is largely based upon the economic and regulatory actions of the 1930's, and in many respects is no longer consistent with the realities of rapidly changing geographic and product markets.

The forces for change are obvious. The handling of paper checks is hampered by rapidly rising costs because of the labor-intensive nature of the check-clearing function. Innovations such as the Federal Reserve's regional check processing centers help to lower costs by reducing the delays inherent in the clearing process. (Earlier innovations have also helped, such as the use of machine-readable magentic ink.) But the day of paperless transactions is approaching, and the proposed Presidential Commission on the payments mechanism may act to hasten that day.

As you are aware, automated clearing houses are operating in California today, and it is only a matter of time before such facilities spread across the country. In another development, the major bank credit-card organizations have introduced on-line nationwide authorization systems, and have also tested hook-ups with point-of-sale terminals at the retail level. Such a communications system, for that is what it amounts to, could provide the basis for a full-scale transfer system linking consumer transactions at the retail level, because the next step is automatically charging the customer's account.

We can infer that the end result will be an electronic payments system in which thrift institutions as well as banks will participate. Although the result will be increased competition, the competitive struggle will show up only in certain areas-- particularly the consumer sector, where S&L's are advertising themselves as "family finance centers." Commercial banks should retain their dominance on the commercial side of banking--an increasingly crucial area, in view of the business sector's heavy reliance on external funds to meet the challenges of the next quarter-century.

Inflation and Financial Markets

Now, up to this point, I've concentrated on the technological, legislative and competitive changes which can be expected to interact to create a new financial environment for the banking industry. Many of the developments I've mentioned are unfolding very rapidly; others are arising only gradually, so that you may have overlooked them in your day-to-day routine. But one thing you won't be able to overlook

when you return to your desks Monday morning will be the reality of the nation's economic problems, especially the severe inflation and the disorderliness of our financial markets.

Recently, questions have been raised in the financial press about the basic health of our banking system. It is true that banks' loan losses have been rising, although not yet to a dangerous level. It is also true that banks have experienced considerable difficulty in raising funds to meet their heavy loan demands. However, there have been very few cases where bank solvency has been called into question. Thus I have no hesitancy in stating that the banking system is in an essentially sound condition, despite the problems created by today's inflationary atmosphere. But if any sound banks run into liquidity problems because of deposit runs, they will receive Federal Reserve assistance if necessary. The Fed will continue to carry out its basic function as lender of last resort.

Questions have also been raised about the wisdom of the recent surge in bank business loans. It should be remembered, however, that a large part of this loan increase represents an accommodation of borrowers whose essential needs could not be met in the commercial-paper and capital markets. It reflects the strength and flexibility of our financial system that when one market falters another can pick up the pieces.

The nation of course faces real financial problems, typified by our record inflation and the high level of interest rates. In most countries today, inflationary expectations have become imbedded in the calculations of lenders and borrowers. Lenders now reckon

that loans will be repaid in dollars of lesser value, and so they hold out for nominal rates of interest high enough to assure them a reasonable real rate of return. Meanwhile, borrowers become less resistant to rising costs of credit because they anticipate repayment in cheaper dollars. Therefore high interest rates are a major result of inflation. To avoid double-digit interest rates, we must do away with double-digit price increases.

Our current inflation began a decade ago on the heels of a dangerously expansive fiscal policy, and the budget situation has actually worsened in the 1970's. In the last five years alone, total Federal debt (including Federal agency debt) has risen by more than \$100 billion--a larger increase than in the entire preceding quarter-century. Even so, our current problems are attributable to more than an overly expansive fiscal policy. During the past several years, we have undergone a series of disappointing harvests, the imposed price policy of the oil cartel, a worldwide boom in industrial demand, several devaluations of the dollar, and the dislocations of on-again, off-again control policies. At times, also, an expansive monetary policy has accommodated the inflationary price trend generated by the forces I've just cited. But the country was unprepared in earlier periods to accept modest doses of anti-inflationary medicine, and so must put up with harsher measures today.

What Can Be Done?

You may ask what policymakers can do to extricate the economy from the present situation of surging inflation and disorderly markets. This question was the topic of several days' hearings before

the House Committee on Banking and Currency in Washington in mid-July. I participated in those hearings, and in my testimony came up with four specific recommendations for an improved policy posture.

First, with regard to both monetary and fiscal policy, I suggested that we explicitly recognize the lagged effects of policy measures, and work within somewhat longer time horizons than has been the custom in the past. As things stand now, the lags in the effects of a change in monetary policy seem to be shorter for production, employment and profits than for prices. With easy money, the "good news" of rising production and employment precedes the "bad news" of rising inflation by a considerable lead-time. Conversely, with tight money, the bad news of a dampening of economic activity comes first, whereas the good news of a dampening of inflation comes much later. Consequently, in our present uphill battle against inflation, we should expand our policy-planning horizon to at least three years to permit the full effects of current policy actions to be realized.

Secondly, Congress should pursue wholeheartedly its present efforts in the field of budget reform. By setting up new machinery that will deal with the budget as a single entity, Congress in effect has created a vested interest devoted to the cause of economic stabilization. For the first time, Congress will now be able to vote on fiscal policy in a logical fashion, instead of in the traditional piecemeal way. Beyond that, it seems essential to push for actual budgets which are restrictive in periods of severe inflation.

The best fiscal policy for fiscal 1975 thus would be a balanced budget, or preferably a surplus, instead of the \$11.4-billion deficit currently projected.

Next, I recommended an amendment to the Employment Act of 1946, which would state explicitly that price stability is a co-equal goal of economic policy, along with "maximum employment, production, and purchasing power." Further, I suggested making explicit in policy decisions the implicit trade-off between full employment and stable prices whenever a conflict arises between these two goals. In the past, our laudable emphasis on the full-employment goal has caused us to downplay other necessary objectives, with the results we see today.

Finally, I argued that the Federal Reserve must have Congressional and Administration support in pursuing a non-inflationary growth target for money and credit, even if that policy should lead to short-run tightness in financial markets and moderate increases in unemployment. In the past, monetary policy has sometimes been pulled off course either by the necessity to finance large-scale budget deficits, or by the attempt to solve structural unemployment problems by broad-scale policy measures rather than by selective measures such as job training and public-service job programs. But we can no longer afford to pull monetary policy off target in this fashion. We should use selective means to deal with specific job-market problems, rather than imposing inflation on everyone by attempting to reach our employment goals through expansionary monetary and fiscal policies.

Concluding Remarks

To conclude, I should return to the football coach analogy, and say that the remainder of the season is likely to be just as bruising as what you've already experienced. When you return to your desks Monday morning, you should have a **fuller** understanding of the fact that the future of the banking system will be based upon an increasingly sophisticated technology and a more vigorous type of competition, as your competitors become full-line "family finance centers" and adopt electronic transfer systems. Banks themselves will compete more with each other, as remote facilities are utilized to expand market shares, and holding company subsidiaries will provide competition on other fronts. In the future, there may well be larger but fewer banking offices--larger to gather the specialists needed to operate a more complex business, and fewer to reflect the displacement of tellers by electronic units. Indeed, with the new technology, fewer customers may be visible around banking offices, although their money will still be there.

As I've already said, many of these changes still lie far in the future, but banks will have to begin planning now for a new financial environment where thrift institutions are challenging banks for the consumer's dollar and where the potential of the bank holding company is being fully exploited. To succeed in this world, it will take bright and aggressive bankers, such as the people I see in front of me. The future of banking rests with managers like you, and I hope that you will find the same excitement and sense of opportunity in the years ahead that you have already experienced in your earlier careers.

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