

NEW HORIZONS FOR BANKING

Remarks of

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I don't think we could find a more timely occasion to get together to discuss the future of banking. The industry is forced to deal today with the after-effects of all the free-wheeling decisions made in the late 1960's and early 1970's, and while cleaning up those problems, it's also forced to deal with the rising challenge from other institutions in traditional banking markets. Probably at no other time in recent decades has your role as directors been more important. It's not so much the management decisions on individual loans and investments--important as they are--that matter today. Rather, it's your strategic decisions on broad bank goals that will determine the ability of your individual institutions, and of the industry itself, to survive and prosper in the final decades of this century.

Consider the role which directors can and must play in the extreme case--a problem-bank situation. If we had to cite single broad reason for bank failure, it would be, quite simply, poor management. Poor management generally is weak, disinterested, uninformed, or even fraudulent, and often it is guilty of poor housekeeping, as evidenced by the lack or insufficiency of internal controls and operating systems. In such cases, directors frequently have abandoned their vital duties and functioned as rubber stamps for inadequate or fraudulent managers. Even in those cases where sound procedures existed, directors often failed to follow up their own directives to ensure that they were being properly carried out.

The importance of a strong, independent board of directors cannot be over-emphasized as the first line of defense in preventing the development of problem situations. But equally, a strong board is crucial in developing

strategies for grasping new opportunities in an industry whose boundaries are changing at a sometimes frightening speed. I hope you can get a better image of the tasks ahead as you participate in this Assembly. In my remarks, I will attempt to deal with the current financial environment and the new challenges of coming decades.

Consider first the current business situation, and the role which monetary policy has to play in this environment. The bicentennial year should be fairly buoyant in some respects, building on the 7-percent annual rate of increase in real GNP experienced since last spring. But now that an adequate growth rate is being achieved, we must concentrate our attention on other problems, such as reducing an almost $8\frac{1}{2}$ -percent unemployment rate. But dealing with inflation may be equally complex, especially since, early in the recovery period, the basic rate of inflation appears to exceed 7 percent. Let me say a few words about one of the key problems in this respect--the impact of soaring Federal deficits on private financial markets and public policy.

Deficits and Monetary Policy

The nation was 186 years old before it first recorded a \$100-billion budget. It took nine years to reach \$200 billion, four years to reach \$300 billion--and it probably will take only two years more to exceed \$400 billion in Federal spending. The basic difficulty has been the failure of Federal budget-makers to find the funds to pay for the growing responsibilities they have taken on, and it has been aggravated by the impact of inflation on many spending programs. The problem threatens to swamp the new Congressional budget committees at the very inception of their activities, but it is one which they must grasp and bring under control.

More Federal spending would aggravate the pressures already evident in financial markets, with unparalleled Federal demands piled on top of gradually reviving private credit demands. This is the well-publicized and all-too-real problem of "crowding out." It's true that financial conditions normally ease substantially during a recession and remain easy even in the initial recovery period. But if the Federal deficit substantially exceeds the Congressional budget target of \$72 billion, total credit demands could rapidly outrun the available supply of funds, forcing interest rates higher and crowding many non-Federal borrowers out of the market. Typically, interest rates fall steadily throughout the early recovery period, but this time they rose. Certainly it's very unusual at this stage of the business cycle to see Treasury bill rates hovering around $5\frac{1}{2}$ percent, or the prime business-loan rate at $7\frac{1}{2}$ percent.

One way that mounting credit demands can be satisfied without an increase in interest rates is for the Federal Reserve to accelerate the growth of money and credit. But if done for too long, or to an excessive degree, such an action could generate inflationary pressures which would soon become imbedded in the nation's price structure. Still, many people reply, with so many idle resources in the economy, how could inflationary pressures arise from easy money at this stage?

The answer, at least in part, involves the lags in the effects of monetary policy, which seem to be much shorter for production, employment and profits than for prices. Of course, it's altogether appropriate to follow a countercyclical stabilization policy. Even so, it's reasonably clear that when an excessively easy-money policy is adopted, the "good

news" appears first, with production, employment and profits expanding within six to twelve months or so--but then the "bad news" arrives, in the form of increased inflation with a lag of one to three years. Conversely, if a tight-money policy is adopted, the bad news of a dampening of economic activity comes first, whereas the good news of a diminished rate of inflation is delayed.

At this stage of the business cycle, the Federal Reserve has to be alert to price considerations, but equally alert to the need to provide the financial basis for continued recovery. In a word, we must maintain a prudent but not parsimonious monetary policy. This stance is seen in the monetary growth path that we're attempting to follow between the third quarter of 1975 and the third quarter of 1976--that is, a 5-to-7½ percent growth rate for the M_1 measure of the money supply (currency plus demand deposits).

This range is quite appropriate in the present environment of high unemployment and unused industrial capacity. On the other hand, it is on the generous side by long-term historical standards. Thus, we could endanger the fight against inflation if we continued expanding the money supply indefinitely at today's specified pace. I might add that the directors of the Federal Reserve Bank of San Francisco currently view inflation as the nation's No. 1 problem. As the economy returns to higher rates of resource utilization, we'll have to reduce the rate of monetary and credit expansion, in order to lay the foundation for a prolonged era of prosperity without inflation.

Current Banking Developments

Now, how has the banking system been holding up against this economic and policy background? The headlines tell part of the story--dramatically so, in some instances. You know the list: W.T. Grant down to its last five-and-dime; the airlines fast losing altitude; the tanker business on the rocks; the jerry-built REIT's crashing to the ground; and New York desperately trying to sell Brooklyn Bridge. All of these have added to the list of bad debts in the hands of financial institutions--commercial banks in particular. Small banks as well as large have had their problem-loan situations, since the broadly-based recession has not been a respecter of location or of size of borrower. But for a more balanced perspective, let's look at the overall banking situation and then see how smaller banks have fared in comparison with the large money-market banks.

Total bank credit expanded at a 3.4-percent seasonally adjusted annual rate in the first half of this year, reflecting a sharp rise in securities investment--a rise which more than offset the 5.5-percent reduction in loans. But then in the third quarter, in the face of rising money-market interest rates, bank credit accelerated to a 4.8-percent annual rate as loan demand began to recover. However, smaller banks consistently outperformed the money-market banks. For example, their loan business was stronger in both the second and third quarters, and in recent months their investment in securities matched the rapid rate of increase for other commercial banks. The difference was most evident in the mortgage field, because of the concentration of troubled multifamily projects in metropolitan areas, but it was almost as apparent in the business-lending area.

Corporate borrowing at banks nationally has remained sluggish even though corporate demands in the capital and commercial-paper markets have abated in recent months. This was reflected in the massive net repayments of business loans in the first half of the year and another (smaller) decline in the third quarter. But business lending was stronger at regional banks than in money-market centers--declining modestly in the first quarter, rising at a greater-than-seasonal rate in the second quarter, and then flattening out in the July-September period. This difference in behavior is not surprising for a period of cyclical trough and early recovery, since regional business firms generally remain steady bank customers because they have less access than large national corporations do to alternative sources of financing. A closer, continuing bank-customer relationship tends to avoid the wide cyclical fluctuations in credit extensions which characterize money-market banks.

Now, throughout 1975, the major portion of bank funds has been channeled into investment in U.S. Treasury securities, although at a sharply reduced rate in recent months. In this drive to rebuild liquidity, banks nationally increased their holdings of Treasuries at an 80-percent annual rate over the first three quarters. The smaller banks generally kept pace with money-market banks in the rate at which they acquired Treasury issues. In addition, they continued to add to their holdings of other securities, whereas money-market banks made little or no net additions of such securities. This greater reluctance of large banks to invest in municipals is understandable because of the New York situation, and also because of their lessened need of tax-exempt offsets to income due to high loan-loss reserves, leasing and foreign-tax credits.

Banks in all size groups have faced up to their problems by making substantial increases in loan-loss reserves, and also by adopting a conservative attitude toward interest rates. As we've seen, the prime business-loan rate recently has been as high as 8 percent--a high level by any standard except 1974, and atypical for the early stage of an economic recovery. The spread between the prime rate and the cost of funds remained unusually wide as market rates moved down. Then, as market rates rose again, banks quickly increased the prime to maintain this favorable spread--even in the face of sluggish loan demand. This policy has given banks a good operating-income cushion to offset their high loan-loss reserves and their slow growth of earning assets.

On the deposit side, banks benefitted in the first half from a 6-percent annual rate of increase in deposits, with a heavy inflow of pass-book savings and consumer time deposits providing them with a relatively inexpensive source of funds. This in turn permitted a sizable \$6-billion reduction in higher-cost large-denomination CD's. In contrast, the third quarter witnessed a slight decline in deposits, as the sharp rise in interest rates brought on disintermediation and thus a revival of dependence on CD money.

The smaller banks bettered the performance of the money-market banks on the deposit side as well as on the asset side. Their passbook-savings deposits increased at a high 20-percent annual rate in the first half of the year. This was about in line with the all-bank average, but it resulted in a greater expansion in total time deposits because of the much larger proportion of time deposits they hold in this form. Disintermediation was

a problem during the third quarter, of course, but as could be expected, it was worse at the money-market banks because of the greater sensitivity of their depositors to favorable interest-rate opportunities. Similarly, in other time deposits, smaller banks had a much more stable experience, because of the small proportion of funds they hold in the form of volatile CD money. Also, smaller banks had a higher expansion rate for demand deposits than the money-market banks did.

As a result of all the developments I've mentioned, it's evident that quality, rather than growth, has become more thoroughly entrenched as the current mode of banking operations. Recent months have brought some surprises and disappointments. Many corporations apparently have improved their liquidity positions enough to start rebuilding inventories without recourse to bank loans. Many potential mortgage borrowers have been discouraged by high mortgage rates and by difficulties in assuring take-outs on new residential construction projects--and also by ceiling-rate limits imposed by state usury laws. In addition, there is the precarious New York situation and the strains it has placed on many banks holding New York securities. This situation, and all the other problem situations I've noted, have led even those institutions not directly involved to redouble their wariness regarding loan commitments and securities investments. Despite the generally improving banking environment, caution is likely to be a hallmark of the 1976 banking scene.

Toward New Horizons

After the experiences of the past several years, bankers may be pardoned for feeling restricted in their near-term planning horizon. But

what of the longer horizon, on the other side of the bicentennial year? There are bound to be many surprises, many difficulties, and many profit-making opportunities--all stemming from current developments with which you are all familiar. It's worth analyzing some of the major developments--to show how, as a group, they create new horizons for banking. Let's consider the challenges arising from four different directions--from computers, from bank customers, from thrift institutions, and from nonfinancial institutions--and consider also the challenge which banking itself poses to other institutions.

Technology should be at the center of our considerations. For example, one of the most significant impacts of technology may be in the area of bank branching. Banks in many cases have increased the size and penetration of their market areas by branching, but at the cost of higher operating expenses and diluted profits. We now realize, however, that branching is not the only possible method of supplying convenient banking services and of improving a bank's effectiveness. Bank managers now have an alternative way of reaching customers through flexible and relatively inexpensive electronic devices. This question may be moot at present, in view of the Federal court ruling that electronic terminals are equivalent to branches, and thus subject to the 48-year-old McFadden Act limiting bank branching. We may have to await a Supreme Court decision on this matter, or perhaps some Congressional decision. (Remember, Sen. McIntyre has suggested that Congress take a good hard look at the McFadden Act, which in effect makes national banks dependent on state branching laws.) Meanwhile, the technology remains available to support far-reaching institutional changes in coming decades.

Against this background, consider the impact of bank customers-- especially through the consumer movement--on the reshaping of the nation's financial system. Sophisticated consumers are now able to obtain high returns from various market instruments and also from money-market funds. Aggressive consumerists meanwhile continue to press for the termination of bank-deposit interest ceilings, which range from zero on demand deposits to 7½ percent on longer-term time certificates. The response is evident in the recent actions of the Senate Banking Committee, which essentially would permit payment of interest on demand deposits at the end of next year and phase out Reg Q ceiling on time-and-savings deposits in 5½ years. Since the House recently passed a bill continuing the ban on demand-deposit interest, the matter will have to be settled in conference committee.

Meanwhile, an increasing number of banks are de-emphasizing the corporate end of the market, in view of all the pitfalls of liability management, and instead are cultivating a larger consumer deposit and loan-base--as most small banks have always done. The consumer market is comparatively stable, statistically predictable, comparatively insensitive to interest-rate changes, and potentially profitable with the help of modern electronic processing. The question then becomes, how will the consumer respond?

The answer depends on the interaction between the rising competitive challenge from thrift institutions and the far-ranging changes in regulatory ground rules. The institutional changes now underway are rapidly blurring the distinction between demand accounts and time-and-savings accounts--primarily of course through the development of NOW

accounts. The public increasingly holds its transaction balances and precautionary balances in time-and-savings accounts, with commercial banks and thrift institutions competing directly for such balances.

In this situation, we might expect the regulatory authorities to attempt to enforce roughly similar ground rules for these competing institutions, in line with a basic Hunt Commission principle. Thus, we have several Federal Reserve actions which would help bring banks into line with thrift-institutions practices--the authorization for commercial banks to offer passbook-savings accounts to corporate customers, and the authorization for banks to offer a bill-paying service to savings-accounts customers. Moreover, we have the Senate Banking Committee's set of proposals, which would further blur the distinction between the different types of institutions, such as by allowing the expansion of all thrift institutions into the consumer-loan and NOW-account fields.

But the challenge arises not just from the thrifts but from other competitors as well; for example, data-processing and communications firms, credit-card companies, and national and regional retailers. These newer enterprises see the change-over in payments technology as an opportunity to enter the payments business without the operating handicap of having to use paper checks processed through commercial-bank channels. Indeed, as Federal Reserve Governor Mitchell has argued, while the banks and thrifts zealously try to limit each other's competitive effectiveness by statutory or regulatory action, they overlook the very strong challenge being launched by unregulated enterprises.

But remember that banks as well as nonbanks can benefit from shifting market boundaries. In recent years, we have seen the expanding power of bank holding companies in a number of non-bank areas. Now, with the upcoming hearings of the Securities Subcommittee of the Senate Banking Committee, we're likely to hear a great deal about the growing strength of the banks in the securities industry. Banks already underwrite Treasury securities and general-obligation municipals; through their trust departments, they are the largest investor in corporate stocks; through term-loan activity, they are important suppliers of medium-term capital--and of course they are heavy lenders to the brokerage industry itself. These extensive bank powers may now increase by default if Wall Street continues to be beset by sluggish trading volume and by the vigorous price competition triggered by the shift to fully negotiated commission rates.

Yet here again, there are changing groundrules. Thus we have the new guidelines proposed not only by the bank regulatory authorities but also by the SEC in its role as protector of investors in bank holding companies. These guidelines represent a difficult compromise between investors' rights and bank customers' rights. In developing them, we have had to weigh carefully the type and form of disclosure imposed on banks, so that we don't undermine the banks' willingness to assume risk--and also don't erode the confidence of depositors, which after all is a key determinant of the banks' ability to attract the funds needed to finance future lending activities.

Concluding Remarks

To sum up, it would seem that the future will be bright, if only we can get there. To ensure that eventuality, there are certain things that public officials and bank directors must do today. Federal budget-makers should reduce budget deficits sharply, to relieve pressures on financial markets and to curb the dangers of inflation. Federal Reserve officials meanwhile can be counted on--to repeat my earlier phrase--to follow a prudent but not parsimonious monetary policy, in order to prepare the way for a prolonged period of full employment without inflation.

Bank directors meanwhile can help support a policy of non-inflationary growth by continuing to emphasize banking fundamentals--the prudent type of policy that Chairman Burns called for in his ABA speech in Hawaii a year ago. This means searching out lending opportunities in industrial projects that will both create jobs and curb inflationary pressures by destroying bottlenecks; equally, it means avoiding speculative projects in non-productive areas, of the type that appeared so favorable in the late '60s and early '70s but have now turned out so disastrously. Despite the headline stories, the industry has moved in the right direction during this consolidation year, especially in view of the strong performance that banks of your size have recorded. I'm sure that 1976 will witness the further success of your efforts.

Finally, what stance should be taken regarding future technological and institutional changes? Certainly, problems will arise from the interplay of the various challenges facing the industry--from computers, from consumers, from thrift institutions and nonfinancial institutions.

To help cope with these developments, we might consider several principles first suggested several years ago to the Hunt Commission by a Special ABA Committee which I chaired. Basically, our committee argued that 1) maximum reliance should be placed upon free-market forces to assure an innovative financial system; 2) regulatory processes should be reviewed continually to ensure that all regulations are justified and administratively workable; 3) public-policy measures for financing the nation's social priorities should provide incentives to all lenders and not just certain specialized institutions; and 4) the ground rules for competition among financial institutions should be equitable, with no substantial limitations on the ability of these institutions to compete with one another.

I submit that these principles have held up well, and that they provide a basis for developing an industry-wide position on the issues first crystallized by the Hunt Commission. But it seems essential that bankers close their ranks and work to forge a unified position on these crucial issues. If they don't, they will find that others have reached those distant horizons long ahead of them.

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