THE COMPETITIVE OUTLOOK IN BANKING

REMARKS BY

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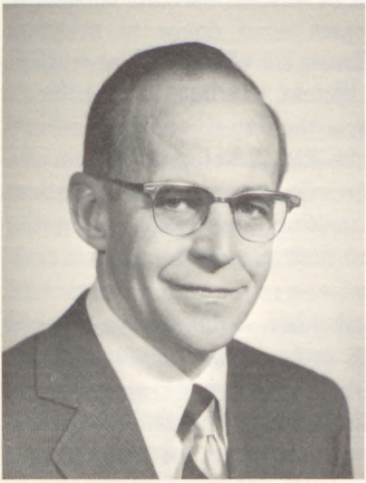
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The management of the American Bankers Association undertook an opinion survey at its recent Dallas convention to ascertain what business problems are uppermost in the minds of bankers. President Eugene H. Adams reports that the most often-mentioned problem was the competitive climate facing the banking industry. More specifically, bankers are concerned about the structure of the banking industry, competition between large and small banks, competition between banks and thrift institutions, and the implications of the Hunt Commission's recommendations.

Your program committee obviously is attuned to these problems, since they have designated the competitive outlook for banking a major subject for this seminar. They may not have been so wise in inviting me to handle the subject, since this is a tall order, and I don't pretend to have all of the answers. Nevertheless, I welcome the opportunity to share my thoughts on this most important topic with you. Hopefully, this will stimulate further discussion and consideration on your part.

Profound forces for change are at work in our financial system. Today I would like to review with you the nature and implications of some of the key developments that are bound to alter existing competitive relationships within banking, and between commercial banks and their principal nonbank competitors:

... The vital thrust within the commercial banking system itself for innovation;

... The drive by other financial institutions increasingly to share the functions and markets of commercial banks;

... The technological revolution occurring in the payments system;

... The emerging change in social values which is likely to impact on financial institutions.

Taken individually, the existence of these trends is not unknown to any of us. But as I began to think about the interrelations and the combined impact of them on the competitive outlook for banking, it seemed to me that many of us have underestimated the degree of synergism at work. Hence my belief that they constitute a profound change when viewed as a package.

Thrust for Banking Innovation

First, as to the vigorous thrust toward greater innovation within the commercial banking industry itself, several leading examples are worth reviewing.

New Financial Instruments — Nondeposit Funds. One innovation represents a response to movements in general credit conditions in the economy. A case in point is the development of new or modified financial instruments during the past decade; witness the massive recourse taken by commercial banks in the nation to nondeposit funds in 1969 and early in 1970. This was a result of the impact of intensive borrowing demands in a situation in which bank access to deposit funds was limited by Regulation Q. Thus, in spite of a net loss of $4 billion in deposits in 1969, banks were able to extend credit by about $16 billion—$12 billion through loans and investments on their own books and $4 billion through sales of loans to affiliates. This was made possible largely by tapping some $20 billion in funds from non-deposit sources, including Eurodollars and sales of commercial paper by bank affiliates. At present, increasing use is being made by bank holding companies of notes and debentures as a source of funds.

The Growth of Bank Holding Companies. A second type of innovation centers on the proliferation of bank affiliates through the creation and active use of bank holding companies. Part of this movement was generated by the search for ways of cushioning the impact of tight money, to which allusion was just made; part, by the search for ways to escape the geographic limitations on branching imposed by some states; and part, by the search for new and profitable ways to offer services to the public that commercial banks are not permitted to provide directly.

The number of bank holding companies is likely to grow, particularly in states where sharp restraints exist over branching. The reason for this stems from economic advantages of the holding company form of organization, as demonstrated by its success in those states where it has had an extended period of operation, and from the greater range of services, closely related to banking, that holding companies can offer. The inevitable result will be to bring about a significant change in banking structure and competition.

Colorado furnishes a good illustration. At the end of last year, the seven multiple-bank holding companies operating in that state held 47 banks with $2,727 million in deposits, representing some 54 percent of all Colorado bank deposits. This was up from roughly 23 percent five years before and from less than 7 percent at the end of 1962. Altogether, there were 58 holding companies headquartered in Colorado on December 31, 1971. Already, in that state, overtures have been made for mergers of holding companies to gain even further advantages. Moreover, I understand that two requests have been placed before the Colorado Bankers Association seeking broad banking legislation, and increasing numbers of bankers are becoming restive for change in the existing geographical restraint.

Other New Services. Commercial banks have also pioneered in the widespread provision of new services both to business, in the form of corporate cash management services and other matters, and to consumers. A prime example of the latter is bank credit cards. Contrary to some beliefs, credit cards are not in the direct line of evolution toward a paper-less financial system; indeed, they generate even more paper than before in the provision of payments convenience to the public. In so doing, however, they helped precipitate the introduction of technology that will be giving a further boost to bank competition.

Expanding International Business. Finally we should note the vast expansion in international services and overseas banking activity of some of the nation's leading banks. Induced largely by a desire to follow their customers abroad in an era of development of major multinational companies, this trend not only has been profitable but also has given a competitive edge to those banks which have engaged in expanded international activity.

The Drive by Nonbank Institutions—Implications of the Hunt Commission

Late last year, the President's Commission on Financial Structure and Regulation issued its report and recommendations. This group, more commonly known as the Hunt Commission, proposed sweeping changes in the powers, functions, and regulation of banks and competing financial institutions. To a considerable extent, the recommendations are said to be aimed at providing more competition among the nation's financial institutions, and less regulation of them, to the extent consistent with safety; and at providing equal ground rules for various classes of competitors. One of the major proposals is to offer commercial bank-type powers to thrift institutions (mutual savings banks, savings and loan associations, and credit unions) if they also assume approximately the same regulatory and tax burdens as commercial banks.

Thus far, the banking industry has not taken a position on the Hunt Commission recommendations, probably because the industry faces a dilemma regarding them. If adopted pretty much in toto (which appears highly unlikely), the recommendations would entail major changes in competitive relationships affecting banks. On the other hand, if adopted only in part through piecemeal legislation at the Federal or state level (which appears more likely), the results may be even more profound for commercial banking. Why do I say this? Because the ability of the heretofore specialized thrift institutions to compete against banks would likely be increased if their lending and fund-raising powers were broadened and made more comparable to those of commercial banks but if their tax burdens, reserve requirements and regulatory structure were not.

Suppose, for example, that savings and loan associations in various states succeeded in getting consumer loan powers and the authority to offer checking accounts to indioffices. A “limited facility” is subject to the branching regulations, but differs from a branch by having specific restrictions placed upon it as to personnel, physical size, capital investment, and/or functions permitted. However, the only practical such constraint is simply “what the market will bear,” according to Federal Home Loan Bank Board Director Thomas Clarke. Such facilities are envisioned as a particularly powerful vehicle for penetrating low-density rural areas.

“Satellite” offices, on the other hand, are provisionally approved entities that offer full service within restraints of other sorts. For instance, they must be located within five miles of an existing S&L office, and are limited in number. No more than five satellites can be established in total, and also no more than two can be installed in any one year. One type of “satellite,” the “counter in a store,” will be confined to retail establishments and may not occupy more than 500 square feet, with a maximum of four teller stations. At these offices, customers may deposit their paychecks, make mortgage payments, or obtain cash — right in the store where they have come to shop.

The second type of “satellite” is the “fully automated” facility, an electronic device operated by a special card given to customers. These machines may be located in a wide range of places such as in retail stores, shopping center malls, office buildings, or transportation depots. Open 24 hours a day, 7 days a week, 365 days a year, such facilities will receive deposits and accommodate cash withdrawals.

The characteristic shared by each of these three new types of offices is that they will enable an S&L to pinpoint and accommodate small, local markets in both rural and urban areas at a fraction of the cost involved in the establishment of a full-scale branch. As Federal Home Loan Bank Board Director Thomas Clarke has claimed, “An S&L can now be just as convenient—even more convenient—than a commercial bank, and so there is no longer any reason to settle for commercial bank passbook savings rates." The key to the great promise of the automated facility in particular is its "kinship with the new breed of electronic and data processing technology which will transform financial transactions in this country . . . to an electronic funds transfer system." "Such a system," he notes, "is absolutely inevitable." Consequently, the FHLBB is urging the savings and loan industry to "begin laying the groundwork for conversion to an electronic funds transfer system at the opportune moment. This means developing present third-party payment authority to its full capacity."

Let me now turn to the subject of computer technology and the payments system, as it affects the competitive outlook for banking.

The Impact of Computer Technology

Until the advent of the computer, the banking business was little affected by technological change, but these changes are now occurring with the prospective impact "on the figurative order of a megaton bomb," to use the words of Governor George W. Mitchell of the Federal Reserve Board. The technology for a completely integrated and automatic payments system is known, is being developed, and is becoming operational. Obviously, this has major implications in the competitive outlook for banking.

First Steps: Regulation J and RCPC's. This month, for example, with the implementation of the revisions in Federal Reserve Regulations D and J, you will feel the effects of one step of the sweeping changes which are to take place. As you know, the new Regulation J has the twin objectives of helping to expedite and rationalize the check-collection process while at the same time viduals and non-business entities. Also suppose that they were not required to maintain the same reserves against checking accounts as member banks must do, but at the same time were permitted to continue benefitting from preferential Federal tax treatment. In that case, their ability to provide services at advantageous rates vis-a-vis commercial banks would be increased, since the ability of any intermediary to compete for deposits reflects the return it can earn on its assets. Hence, to the extent that differing reserve requirements, regulatory limitations, and tax burdens influence asset mix and earnings, the ability of the various types of institution to compete for deposits will also vary.

Thus, if thrift institutions are to be provided with broader lending, investment, and deposit powers (including checking accounts) that are more akin to those enjoyed by commercial banks, it will be vital, in the interest of competitive equality, that they assume in commensurate degree the same burdens as commercial banks — i.e., reserve requirements, ceilings (if any) on interest rates payable on deposits, regulatory constraints, and tax treatment.

Changes Now Taking Place— Thrift Institutions

But while the debate on the Hunt Commission report goes on, a number of changes in the powers and functions of thrift institutions are even now taking place, and it is to these that I wish to call your attention.

Regulatory Actions of the FHLBB. The first development which I would like to emphasize involves the numerous regulatory changes implemented over the last year or so by the Federal Home Loan Bank Board, which were designed to strengthen the position of savings and loan associations.

1. Broadened Lending Authority. These changes not only embrace substantially broadened lending powers in the field of real

estate financing, but also permit savings and loan associations to make loans for major home appliances and built-in equipment (up to 5 percent of assets, as authorized by the HUD Act of 1968). Included in the latter group are loans for the financing of wall-to-wall carpeting, central air conditioning, food freezers, lawn sprinkler systems, water systems, and installed workshop equipment—items that comprise a large portion of consumer-durables financing.

2. Third-Party Payments. Still other regulations, adopted in 1971, authorize savings and loan associations to make non-negotiable transfers from savings accounts to third-party payees for a wide range of transactions more or less related to housing and home occupancy. They cannot, however, arrange such payments for food, clothing and automobiles.

(Similarly, although not subject to the FHLBB regulations, mutual savings banks and credit unions in a number of states are now offering, or are seeking to obtain authority to offer, a wide range of third-party payments services—including checking accounts.)

3. Capital Structures. Through yet another regulatory action the Federal Home Loan Bank Board has proposed approval for savings and loan associations to issue subordinated debentures, and has lifted the moratorium on conversions from mutual to stock associations, in order to provide increased flexibility in the raising of funds.

4. Branching Regulations. Finally, branching regulations have been adopted that will give savings and loan associations a number of new possibilities to serve the public. These are worth reviewing in greater detail in view of the competitive implications for commercial banks.

Limited Facilities and Satellite Offices. The new regulations will permit the establishment by savings and loan associations of so-called "limited facilities" and "satellite" (or "mini") reducing Federal Reserve Float. The simultaneous lowering of reserve requirements under the new Regulation D is intended to minimize the transitional impact on member banks.

Another significant development in Federal Reserve activities affecting the payments mechanism over the past year has been in the area of Regional Check Processing Centers. Each Federal Reserve Bank has either proposed, planned, or implemented one or more "RCPC's" in its District. At the Federal Reserve Bank of San Francisco, we expect to have RCPC's operational at each of our five offices by early 1973.

As you know, the basic function of an RCPC is to provide the manpower and equipment, geared to later deposit deadlines, at locations where large concentrations of check volumes can be expeditiously processed and collected. Our goal is to furnish the earliest practical availability of funds to our depositors and ultimately to the public. Furthermore the Federal Reserve System is beginning to look ahead to the next steps in improving the payments mechanism.

SCOPE. Ancillary changes in the payments system, which are in the early process of development or in the implementation stage, include the much-publicized SCOPE project in California, initially conceived and promoted by ten major banks in the state. The system provides for pre-authorized paperless entries to effect payments in lieu of checks. The nerve center of this project lies in two automated clearing houses, located in the San Francisco and Los Angeles offices of the Federal Reserve Bank of San Francisco. For the bank customer, the system involves both credit entries to his checking account in the form of payroll depositing, and debit entries in the form of regularly recurring payments of such items as utility bills, mortgage loans, and insurance. Now in the process of being implemented by some

145 banks which account for 90 percent of the banking business in California, SCOPE-type projects are under active consideration by banks in some 20 or more other areas in the nation. Significantly, the possibility of participation in such programs by departments and agencies of the Federal Government is being carefully studied.

The Atlanta Project. Other significant developments in the electronic funds transfer area include the Atlanta payments project, which, in addition to the automatic deposit of payrolls and a pre-authorized, paperless system for paying bills, has proposed to offer "bill-checks." These bill-checks will use machine-processable documents on which the payor endorses a bill and stipulates the amount and date on which his bank is to debit his account and effect payment to the creditor or the vendor-payee.

Computer Terminals in Retail Stores. Going beyond these projects is the point-of-sale computer terminal in retail stores, activated by a consumer's card, and providing a direct hookup with a bank's computer and authorization terminals. Indeed, as envisioned by a number of observers, what these arrangements eventually will entail is a system of computerized telecommunications linking home and business with the market, including vendors and those institutions which administer the payments mechanism. These institutions — commercial banks and possibly other financial and non-financial institutions —will be grouped into a series of local systems, with access to a central data bank containing a variety of information on customers. The local systems will be linked into regional centers which in turn will be linked to an integrated national system of computerized telecommunications.

Implications for Banks of Electronic Payments System

In assessing the implications of an electronic payments system for the competitive outlook in banking, the first and basic consideration to you as bankers must be the great opportunity it will afford for expanding the scope and variety of your services. There is little doubt that banks (or their competitors) will be in a position to accommodate a very wide range of bill-paying and account-keeping functions of consumers, businesses, and governments alike.

Larger Banks and Fewer Banking Offices. At the same time, the era of less-checks and instant communications between businesses, consumers, vendors and bank computers is likely to witness at least some tendency towards the concentration of business in large or regional banks. The reason is that such banks will be able to serve customers that are not in close geographical proximity to them, and hence will offer more competition to small local banks.

Consequently, the development of an electronic payments system may be a force working toward a decline in the number of small banks and of branch offices. An electronic transfer system reduces the need for the bank customer to visit his bank office, either in the capacity of a depositor or borrower. If the customer can bank through his telephone and have his bills paid and funds deposited automatically, proximity to a bank office *per se* will become less relevant. By the same token, an electronic payments system is certain to break down geographical barriers, and in the process render obsolete many existing legal barriers to competition such as branch restriction and home-office protection laws.

Changing Role for Correspondent Banks. What, then, of the correspondent banker? Clearly, a very important function of the correspondent today—clearing checks and other cash items—will greatly diminish in importance. Yet, the new and varied services that are likely to develop in connection with an electronic payments system could result in new correspondent ties in the way of specialized services. Consequently, one key to the survival of the small bank may depend upon its ability—perhaps through pooled facilities and leasing arrangements—to work out with its city correspondent the means of participating in the new services and markets offered by an electronic system, without independently having to undertake the costly investment involved in the necessary hardware and personnel.

Competition from Non-Banks. The electronic funds transfer system is also likely to impinge upon commercial banks as competitive nonbank financial institutions enter the third-party-payment field and utilize the latest technological developments in the process. It is the view of some observers that nonbank firms increasingly will attempt to move into the payments system, which has long been the nearly exclusive domain of commercial banks. These potential entrants include not only savings and loan associations and mutual savings banks but also data processing firms, specialized service bureaus, large retail firms, and possibly some elements in the communications industry itself. Not overlooking the advantages of modern technology in their own operations, they will deny to the banking industry the luxury of doing business just the way it was done before.

Changing Social Values

Finally, there is another fundamental force for change which is increasingly evident in our body politic and which has an important bearing on the competitive outlook for banking. I caution you against underestimating the potential impact of it. For better or worse, some groups in society are raising questions as to the appropriate balance between social ends and means. More specifically, questions are being raised regarding the consistency of traditional economic goals —high and rising levels of income, output and consumption — and considerations regarding environmental and ecological balance.

Effect on Financial Institutions. This growing concern has important implications for the nation's financial institutions as well as for economic policy. As examples I would cite the growing support for construction moratoria in some areas, and the increasing antagonism towards development.

This is, of course, a matter of concern both to financial institutions and to policymakers simply because economic growth — which means more jobs and more income—is related to the pattern of real-resource allocation, which is affected by the pattern of financial flows. The latter, in turn, is influenced by the structure of financial institutions and the rules under which they operate.

The outcome of the growing debate is not certain. However, it would appear that, partly under the impact of the environmental movements, a stabilization—and even decline—in homebuilding and other forms of construction already is occurring in some areas. If environmental concerns become more pervasive, then types of activity which involve a heavy throughput of materials (such as construction) will be viewed with progressively less favor. If so, this clearly has implications for the likely course of action by heretofore specialized thrift institutions which have been primarily engaged in financing these types of activity. More specifically, pressures on their part for diversification into other fields—including several fields dominated by or reserved to commercial banks—can be expected to increase.

Need for Flexibility. It is partly for this reason—the fact that the social priorities of the future may well differ from those of today—that the increased flexibility in operations envisioned for banks and their nonbank competitors by the Hunt Commission would appear to some observers to have considerable merit. In their view, such a system would be preferable to the present one, which induces thrift institutions to specialize in real estate lending and which offers less freedom of action to commercial banks. In any event, it is clear that maintenance of the *status quo* is not one of the options open to commercial banks.

Summary and Conclusion

With these remarks, I have attempted to identify the nature and the implications of some of the major forces in the competitive outlook for banking. Stemming from innovations within the banking industry itself, from the drive by thrift institutions for bank-type powers, from the technological revolution in the payments system, and from changing values in our society, these forces for change are certain to exert an increasingly powerful influence upon the competitive environment in which you, as banks, are going to live.

More specifically, the changes now in the air suggest an increasing reliance by banks on non-deposit sources of funds; a growing importance of bank holding companies, both in banking and in "closely-related" fields; a continued proliferation of new and imaginative services by banks to business, consumers, and governmental bodies; a further growth in importance of international banking; a major drive by thrift institutions (mutual savings banks, savings and loan associations, and credit unions) in directions that have the potential of sharing increasingly in the functions and markets of commercial banks; a major revolution in the payments mechanism of the country and in the role of banks in that mechanism, with an inevitable impact on the functions of correspondent banks; and changing social values which may have an important effect on banks and other financial institutions. I urge that you be prepared to cope with these changes when they come.

A famous economist and former banker, the late Joseph Schumpeter, once described the capitalist system as one characterized by "a perennial gale of creative destruction." The assessment may seem a little severe to those seeking solace, but certainly changes are in the air, and most assuredly, they are not just of a seasonal nature.