

WHERE IS BANKING HEADED IN THE 1970's?

By
Darryl R. Francis
To the Wisconsin Bankers Association
Bank Executive Seminar
At University of Wisconsin, Madison, Wisconsin
February 3, 1971

I am delighted to have an opportunity to participate in this Seminar for Wisconsin Bank Executives. The assigned topic "Where is Banking Headed in the 1970's?" is both intriguing and challenging. Changes will occur, if the past is any guide. Economic conditions vary, financing requirements change, banking laws and regulations are altered, and bankers with ingenuity innovate in their efforts to maximize income.

Need for Outlook

Despite the inevitable pitfalls of forecasting, some reflection by bank executives on probable future developments is beneficial. If changing financing requirements are to be met most efficiently, banks must prepare early. They must keep pace with community evolution, or their contribution to society will lessen, and the banks will suffer. Fortunately, most new trends develop gradually, and through diligent and continuous application and study, bank management has been able to survive and prosper in a changing environment. Educational conferences, like the Wisconsin Bank Executive Seminar, have been helpful in preparing bankers for change.

A projection of the future should most logically begin, I think, by an analysis of the present and recent past. Where are we now? What seems to be the most recent trend of developments? What are the major forces that are likely to change the course of banking?

General Observations

Before discussing the probable course of some specific developments, I would like to make two general observations about developing trends in banking. First, banking has become more competitive in the past decade. The competition is not only keener among commercial banks, but between banks and other financial intermediaries. I believe that bank competition is likely to be even greater in the 1970's than it was in the 1960's.

Second, the field of banking has broadened greatly in the recent past as to both sources of funds and their use. Many commercial banks have also entered into nonbanking activities. Use of the bank holding company device to expand activities has increased rapidly. These trends toward a wider scope for banking are likely to continue in the 1970's.

Sources of Bank Funds

The traditional sources of bank funds have been bank capital, demand deposits and non-negotiable time deposits. In

the early 1960's banks began issuing negotiable certificates of deposit, and security dealers developed a secondary market for large CD's. The volume of CD's increased rapidly, from about \$1 billion in 1961 to over \$20 billion in 1968. The pattern of growth was abruptly reversed in 1969 when yields on competing assets rose above the Regulation Q interest ceilings that banks were permitted to offer on CD's. After the interest ceilings were relaxed in January 1970 and again in June and when short-term market interest rates declined, the volume of CD's again increased sharply.

The CD has proven to be an efficient means for banks to obtain funds. Banks have provided a useful intermediary service between large investors and large borrowers, and when given freedom to compete in the market on a rate basis, banks have been successful in attracting funds and investing them profitably.

For purposes of projecting, I am assuming Regulation Q will not again become an obstacle to banks in obtaining CD's, since I see no reason that it should either for stabilization purposes or for allocating available funds. If this assumption is correct, large CD's, and smaller certificates as well, are likely to prove a major and growing source of funds to commercial banks during the 1970's.

The rate of growth of CD's, however, will probably

be less in the 1970's than in the 1960's, since the potential of attracting existing funds which formerly flowed through other less-efficient avenues is now reduced. Also, as a result of the 1969 experience, holders of funds are now more familiar with alternative investment opportunities, which may now give banks more competition in seeking CD's.

Large commercial banks in the United States developed Eurodollar borrowings as another source of funds during the 1960's. Holdings of Eurodollars by large U. S. banks expanded from about \$1 billion in early 1964 to a peak of \$14.5 billion in mid-1969. The most rapid expansion of Eurodollar holdings by U. S. banks occurred during periods when Regulation Q prevented banks from effectively competing for CD funds and when loan demands were particularly strong. Eurodollar holdings of large commercial banks nearly doubled in the first half of 1969. The volume remained large despite a placing of reserve requirements on Eurodollars in late 1969.

Eurodollar borrowings have been a marginal source of credit to most banks. Once banks could effectively attract CD's funds in 1970, their holdings of Eurodollars declined. The decline has continued even though the Federal Reserve System has provided incentives in the form of a reserve-free base for those banks maintaining these borrowings.

Looking into the future, money markets in various parts of the world are likely to remain interrelated, and Eurodollars will probably continue to provide an alternative source of funds to large commercial banks in the 1970's. However, as long as banks are free to compete for domestic funds, and as long as the international flow of capital is hampered by U. S. and foreign government regulations, it is not likely that Eurodollars will become a major source of domestic commercial bank funds.

Another source of funds developed by banks in recent years is commercial paper. Reserve requirements were placed on funds banks obtained by selling commercial paper, in part to limit growth of this source of bank credit. The practice, however, continued, with bank holding companies selling the commercial paper and using the funds obtained to buy loans from the commercial bank. Bank related commercial paper expanded \$5.5 billion during the 11 month period ending July 1970.

Since last July, the volume of bank related commercial paper has declined. Reserve requirements were placed on such commercial paper in August 1970, making these funds less attractive. Also, the greater availability of funds through CD's has reduced the incentive for banks to seek funds through commercial paper.

The future role of nondeposit sources of bank funds, such as Eurodollar holdings and bank related commercial paper, depends to a large extent upon the course of Federal Reserve regulation. Reserve requirements on these nondeposit sources of funds have been factors in reducing their attractiveness. However, if the System should again permit the interest rate ceilings to again effectively restrain banks from attracting CD's and other time deposits, it is quite likely that commercial banks will develop commercial paper, Eurodollar, or other nondeposit sources of funds. Since these other markets have usually been less efficient than the time deposit market, it would seem desirable for public policy to permit banks to compete for time deposits. Growth of time deposits is not inflationary, since banks are not creating new credit but merely acting as an intermediary between the supplier and user of funds. Government attempts to improve the allocation of funds through regulating markets, have generally caused more misallocation.

Uses of Bank Funds

There have also been changes in the use of funds reflecting competition among banks, innovations of bankers, and economic change. Developments include a growing importance of loans in bank portfolios, an improved management of excess

reserves, and an expanding role of banks in leasing equipment to their customers.

At the end of World War II, commercial banks were highly liquid. Cash and Government securities amounted to 79 per cent of total resources of banks, and loans accounted for only 16 per cent. In the postwar years the demand for customer credit has grown much more rapidly than bank sources of funds.

By late 1970, commercial banks had 55 per cent of their resources in loans. Cash and Government securities accounted for 25 1/2 per cent of assets.

The postwar trend toward less liquidity in bank assets will probably come to an end in the next few years. The chief limiting factor, as I see it, will not be liquidity considerations, however, since with the more developed Federal funds market, the ability of banks to attract CD's and non-deposit sources of funds, and the Federal Reserve as lender of last resort, the need for liquidity in asset holdings is not large. Practically, many banks are running up against a limit in converting assets into loans. Reserve requirements and cash needs for transactions are likely to prevent much further decline in the relative importance of cash. For many banks Government security holdings - at least before the recent cyclical bulge - were virtually nonexistent, beyond those securities pledged to hold deposits.

If further customer accommodation is not forthcoming from a redistribution of assets, and if loan demand continues to grow faster than demand and savings deposits in the 1970's, as appears likely now, banks will be forced to compete even more vigorously for CD's and other sources of funds if they are to maintain their present relative position in the lending market.

Banks, particularly smaller ones, have become more efficient in utilizing funds available to them in recent years, as indicated by a decline in excess reserves. The ratio of excess to total reserves at country banks has gradually declined from about 8.5 per cent in 1961 to about 1.5 per cent in 1970. Many factors have contributed to the trend. Growth in average size of bank, both from operations and structural changes, has made management of cash more profitable. Higher interest rates have added to the rewards for efficiency. More highly developed money market instruments - particularly Federal funds - have improved the possibility of minimizing redundant funds.

Banks will probably continue to hold average excess reserves to a much lower level than in the early sixties even if interest rates should decline to the levels existing at that time. Since banks have developed outlets for utilizing funds for short periods and since average bank size is continuing to increase they will probably find it profitable

to avoid relatively large excess reserves.

Commercial banks have also expanded their leasing operations in recent years. Leasing of equipment has in many cases provided advantages over a cash loan, both to the bank and to the customer. Leasing has provided tax benefits, reduces capital requirements of borrowers, and better enables those banks that are short of funds to refinance. Leasing arrangements are likely to continue to grow, and this development tends to broaden the activities of banks.

Monetary Developments

Growth of the commercial banking system will be influenced by the trend of bank reserves supplied by the Federal Reserve System. The volume of reserves supplied will be greatly affected by economic conditions, and, assuming a continued moderate growth in the trends of spending, production, and incomes, bank reserves are likely to grow at a moderate rate.

Although reserves have a large effect on commercial bank growth, no one bank, or even the entire banking system, need necessarily grow at this same rate. Individual banks by attracting or losing deposits, of course, can grow either faster or slower than the banking system. Also, the entire banking system might expand faster or slower than the reserve base, depending on type and location of deposits. Then too, growth of reserves provided by the Federal Reserve System depends to some degree on the extent that they are used to

support demand deposits and the extent that they support time deposits.

Monetary policy and its implementation may have a different effect on commercial banks during the 1970's than it had in the 1950's or 1960's. In the earlier period, policy formulation and implementation were based almost entirely on interest rates or closely related market phenomena. As a result, market interest rates tended to be smoothed in the short run, but at times these actions contributed to economic instability and large cyclical swings in interest rates.

Beginning in early 1970, the Federal Reserve System began placing more emphasis on money stock and other monetary aggregates in monetary policy formulation and implementation. Interest rates have continued to play a role, but their importance has been reduced. In my opinion the trend toward the use of monetary aggregates and away from interest rates in policy implementation will continue in the 1970's.

As this shift proceeds, market interest rates may fluctuate over a wider range within short periods of about four months or less. Commercial banks may be faced with more rapidly changing interest rates when there are changes in any of the myriad forces affecting either the demand or supply of funds. On the other hand, as the System places more emphasis on monetary aggregates, it is likely that fewer destabilizing monetary actions will be taken. Hence, broad cyclical swings in both economic activity and interest rates may be moderated.

Changing interest rates create problems, as well as opportunities, for financial intermediaries. Rates on loans must be frequently adjusted, and care must be taken not to get unduly locked-in at low rates on term loans. Rates paid on time deposits must be adjusted, downward as well as upward, and I do not think it is wise for banks to attempt to get the Government to make this tough decision for them by regulations. There is little evidence that regulations improve on market forces in making such adjustments, yet freedom is lost when regulation increases. Establishment of rates will be one of the tough problems for bankers in the 1970's. Pricing decisions are always difficult since the demand schedules facing a firm are only imperfectly known, and actions of competitors can influence them greatly.

Economic Growth

Technological change and overall economic developments are also likely to alter the course of banking in the future. Examples are the development in data processing equipment, wire transfers, demand for faster movement of funds, the rapidly expanding volume of financial transactions with a growing economy, and growing use of credit cards. The coming decade is likely to be the period when commercial banking makes a major move toward further automation. Rising labor costs plus the rapid growth in the volume of paper work are powerful

incentives pushing banks into mechanization.

Developments in other financial institutions are also likely to affect commercial banks. For example, banks are likely to receive more competition for deposits as a result of the greater ability to transfer savings and loan shares, and the rapid growth of commercial paper. The only function of banking which is peculiar to commercial banks is maintenance of customer checking accounts. Other agencies can perform most banking functions, and the efficiency with which other agencies perform these functions must be surpassed or matched by banks, if banks are to prosper.

Bank Structure

Probably the most controversial of all changes in the commercial banking in the coming decade will be changes in the structure of the industry. Our commercial banking structure evolved within a framework established by both Federal and State regulations. Such regulations include controls over chartering new banks, bank mergers, branching and holding company formations and acquisitions. These controls often tend to inhibit bank competition, innovations in banking and banking efficiency.

Bank efficiency might improve and competition increase, both among banks and between banks and other financial firms,

under more liberal banking structure laws. With the prospects for greater automation in banking and the rising volume of ancillary bank services provided to bank customers, the efficiency gap between the more highly controlled bank systems and those free to branch, or expand through holding companies will be widened.

Multiple office banking has expanded rapidly since the early 1960's, while the total number of banks in the United States remained nearly unchanged; the number of branch offices and facilities doubled, rising from 10,969 to 21,882. The number of multiple bank holding companies rose from 47 to 97 in the last ten years, and the number of banks affiliated with multiple bank holding companies rose from 426 to 723. Currently, banks affiliated with multiple bank holding companies account for about 5 per cent of all commercial banks in the nation and 14 per cent of all commercial bank deposits.

In addition the growth of bank assets owned by one-bank holding companies accelerated in the latter part of the 1960's. These banks participate in bank-related activities such as data processing, insurance, and mortgage lending through other subsidiaries of their holding companies, which may be located in almost any geographic area. In 1955 there were only 117 one-bank holding companies in the nation and their bank subsidiaries held total deposits of only \$11.6 billion or about 6 per cent of the national total. By 1965, the number of one-bank

holding companies had risen to 550, but their bank deposits totaled only 4.5 per cent of the national total. By the end of 1969 the number of such companies had increased to 890 and the bank deposits held by their banks had risen to 43 per cent of the national total.

This rapid expansion of individual banking organizations into new geographic areas, as well as into new fields of activity, is likely to continue through the 1970's. As indicated earlier, technological innovations introduced into banking are likely to continue. Such innovations generally provide greater benefits to the larger firms where more specialization of labor is possible. The pressure for the formation of large banking systems is therefore likely to be greater than heretofore, increasing the demand for more liberal banking laws in those states with highly restrictive controls.

There have been only a few changes in state laws relative to bank structure in recent years, but most changes enacted were toward less restrictive provisions. During the 1960's, New York, Virginia, New Hampshire, and New Jersey liberalized their branching laws. More recently the Arkansas legislature passed an act prohibiting multi-bank holding companies.

There has been a trend toward bank expansion into closely related activities and toward multiple office banking during the past decade.

In the absence of excessive concentration it is my view that most holding company and branch applications have been looked on favorably by the national authorities.

The issues relative to bank structure are of major interest to most bankers. They are also of interest to the public and to public officials. Part of our hodge-podge of banking legislation dates from the early 1930's when many bank failures had occurred. These failures were generally attributed to excessive competition in banking. We now know that most of the problem was the result of monetary actions which led to a decline in the stock of money by 1/3 over a four year period.

State laws relative to bank branching vary widely. Statewide branching is predominant in the Western states and on the East Coast. Limited branching is predominant in states between the East Coast and the Mississippi River, while most states between the Mississippi River and the Rocky Mountains are unit banking states. State laws with respect to holding companies are likewise highly variable. Some states prohibit multiple bank holding companies altogether. Others permit holding companies but restrict their operations and still others permit bank holding companies with state approval, while about half the states have no bank holding company legislation.

Rigidity with respect to bank regulation is not without

its cost. Many communities are not getting banking services at competitive prices. When some banks fail to pay interest on savings and time deposits under the relatively high market rates of recent years, we know that something is wrong. Not only are some banks able to ignore market forces in buying funds, they also can ignore market forces in selling funds, i. e., lending to customers.

In addition to these inefficient practices of a few banks, we often observe areas where fund flows are inconsistent with a competitive national market. Some local communities, for example, have an excess of funds for local investment at competitive rates rather than offering the excess funds to other market areas which are short of capital and are willing to pay higher rates. The unit banks which are more closely attuned to the national money markets pay market rates for savings and charge market rates on loans.

The bank which is both paying and charging market rates is performing the maximum service to its community. It is attuned to demands of both savers and borrowers. On the other hand, those banks which can ignore market forces are not performing at potential competitive levels. I believe that much of the below maximum potential performance of banks can be traced to excessive protection provided by our bank structural laws.

I believe that our state and national officials will not stand by indefinitely and permit the poor performance of financial agencies to stifle economic development where that situation exists. I see no reason why all citizens should not have access to returns on savings at competitive rates and the use of borrowed funds at competitive rates. If we do not provide for a banking system that will do this job, other institutions will eventually replace banks in areas where the failures persist.

Financial markets perform best in areas subject to the competitive forces of larger banking systems. This does not mean that unit banks cannot compete. Well-managed unit banks can be found in all states and localities regardless of the prevailing banking structure. They must, however, recognize market forces, be willing to take advantage of new technology, and perform at maximum efficiency levels. With alert management unit banks can compete within any system. It is my belief, however, that the isolated inefficiencies in the unit banking system will contribute to further gains in multi-office banking, and that such gains in the seventies will perhaps accelerate compared with the sixties.

Concluding Comments

In conclusion, the opportunities for commercial banks are great for the decade of the 1970's. Banking is a dynamic industry.

It is growing and changing as a result of developments within banks, supervision, the economy, and competitors. Competition is keen and probably increasing. Costs have been rising steadily and are likely to continue to increase. As a result of these developments, successful banks will need to be guided by capable management. I have confidence that commercial bankers will meet the challenges of the future as they have those of the past.

The structure of banking is in for further change in the 1970's. Pressures for a banking system that provides for greater efficiency contributed to major changes in the 1960's. Such pressures will likely be greater in the 1970's, and the changes will likely accelerate. Most changes in state laws during the past decade have been toward less regulation with respect to bank structure. In addition, it is being increasingly recognized that inefficient financial institutions retard economic growth.

I believe that every community has an equal right to market rates on loans and on savings. We know that some isolated banks fail to provide these services at competitive prices.

The demand for these financial intermediary services will continue to grow. If the current banking system cannot or will not provide them efficiently, the community will demand another type of banking system or other financial institutions. I believe that banks can do the job provided they have freedom to bring all areas into competitive financial markets.