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The Changing Environment for Banking

J. Charles Partee

For anyone connected with the banking business — whether banker, analyst, or regulator—it is abundantly clear that we are in the midst of a period of rapid and perhaps quickening change. The evolution taking place in financial services no doubt creates new opportunities for well-managed, innovative institutions. But it also poses substantial risks that may require changes in banking strategy and that will warrant close monitoring and careful evaluation.

The list of challenges today is extraordinarily broad. Interest rates, after dropping sharply in the spring, have escalated again to approach their unprecedented highs of early 1980. Rate volatility is without parallel in modern times, and financial markets have shown considerable instability. The competition for deposit funds is intense, and it is coming increasingly from the attraction of alternative market instruments as well as from inter-institutional rivalry. Major new shifts in the competitive environment are in the process or on the horizon, including nationwide NOW accounts on January 1, 1981, expanded lending authority for the thrifts, the explicit pricing of Federal Reserve services, the accelerating trend toward electronic funds transfers, and the gradual phaseout of all Regulation Q interest rate restraints. And all of these changes are taking place in an economic environment marked by continued rapid inflation, sluggish business, escalating energy costs, and uncertain adjustments in the structure of geographic and product markets. Credit risk potential obviously is on the rise.

So far, the banking community has weathered the storm very well indeed. This past year has not been an easy one for banking, given the effects of rapid inflation, a sharp but brief economic recession, and the wide fluctuations in interest rates. Yet, on balance, bank earnings have held up or increased, bank capital ratios have shown some small tendency toward improvement, and there has been no evidence of any widespread buildup in problem loans of the sort that plagued us in the mid-1970s. There is reason for optimism, therefore, about the adaptive capacity of our banking system. But to ensure continued success during this difficult transition period, it is vital that we all recognize the need for changed banking practices in order to cope with the challenges at hand.

Competition for Deposits

In my view, the most fundamental challenge confronting banks — as well as other financial institutions — is the escalating competition for deposit funds. For many years, banks were able to depend on a growing and reasonably stable base of low-cost core deposits, mainly demand and passbook savings accounts. This situation began to change about 15 years ago, however, and in recent years rising market interest rates have encouraged holders of these deposits increasingly to seek out other types of financial instruments offering substantially higher yields. Depository institutions have faced the prospect of either gradually losing their deposit base, or else offering more attractive deposit instruments in order to hold and add to their funds. Small banks have been under particular pressure to innovate because they rely more heavily on core deposits.

With the help of liberalized Regulation Q rules, most institutions have wisely chosen the latter course. Thus, in June 1978, the depositories began to market six-month money market certificates for savers with a minimum of $10,000 to invest. These certificates, which are issued at interest rates pegged to yields on six-month Treasury bills, have proven extraordinarily popular with individuals. In less than 2% years, the amount outstanding at all institutions has risen to $355 billion, of which commercial banks hold $150 billion. Similarly, the small-saver certificate, introduced in the summer of 1979, has helped institutions defend their position in this segment of the market. These certificates have a maturity of 2% years, and their interest rate is tied to yields on Treasury securities, with a ceiling cap presently of 12 percent for thrifts and 11¾ per cent for the banks. Although they have been available only for a little more than a year, the amount outstanding has already risen to nearly $90 billion.

Relatively small savings balances thus have become increasingly rate sensitive, just as large certificates of deposits had earlier, particularly after banks were freed from rate ceilings in 1970 so as to compete successfully with the market. The result has been a sharply rising cost of funds for banks, large and small. Equally important, the cost of funds is no longer predictable, since it will need to vary relatively promptly in order to keep the returns paid for such deposits competitive with the market. But let me be clear: There is no alternative. The institutions would not have been able to keep their deposit base without these new, free-floating instruments. And with the open market still beckoning for new sources of funding, there is no turning back from this course.

Probably the greatest competitive threat that the depositories have had to face from the market in the last several years has been money market mutual funds. The combined assets of these funds have exploded from only $4 billion at the end of 1977 to nearly $80 billion currently. The money market funds have proven to be the most effective alternative to deposits yet devised for the consumer. By participating in such funds, the consumer is able to receive short-term yields without the expertise required to buy market instruments directly. Most funds also offer the consumer liquidity by having a draft redemption feature. While the funds are not insured, the investment risk appears relatively low because the pool of investments is composed of a diversified portfolio of high-grade assets of very short-term maturity.

Although money market mutual funds so far have attracted far less in savings balances from individuals than money market certificates and small saver certificates combined, they nevertheless have seriously challenged the position of the traditional depository institutions. Moreover, they symbolize a threat to the future of the depositories posed by an open market environment — that is, the threat that additional deposit-like financial instruments may be developed in the money market or by non-depository firms. In this competitive environment, it seems to me essential that the depositories be freed from the long-standing interest ceilings on deposits that have restricted their ability to compete against the market. The Monetary Control Act passed by the Congress last March does just that, by providing for a gradual phasing out of Regulation Q, and the Depository Institutions Deregulation Committee is now carrying out this statutory mandate.

Another less publicized provision of the Monetary Control Act that has implications for deposit competition is the increase in deposit insurance coverage from $40,000 to $100,000. With this increased coverage, banks and thrift institutions can now issue $100,000 certificates of deposits that are both fully insured and free from deposit rate ceilings. These features can make these certificates a highly competitive instrument for attracting funds from wealthier individuals who perfer to invest in a relatively liquid, perfectly safe financial instrument.

Recently a group of small banks has used the increased insurance coverage to their advantage in a unique way. These banks, through a bankers' bank named the Independent State Bank of Minnesota, were able to sell a large money market mutual fund a $4-million package of $100,000 CD's, all issued individually by the group of small banks and all carrying the same interest rate and maturity. This novel transaction illustrates one way small banks have found to retain funds in the current highly competitive deposit market environment.

Looking just slightly ahead, another major change is about to have an impact on the market for deposits. On January 1, both banks and thrift institutions throughout the nation will be able to offer NOW accounts. These accounts were first introduced in Massachusetts and New Hampshire in the mid-1970s, and it is estimated that about two-thirds of all household transaction accounts currently are in NOW accounts in those two states. In 1976, NOW accounts were extended to the remainder of New England, and more recently to New York and New Jersey.

When banks in all states begin to offer NOW accounts in 1981, they will necessarily incur an increase in their average cost of funds. In order to get some idea of the magnitude of this increase, we have reviewed the New England experience in the period following their introduction. In Massachusetts and New Hampshire, it is estimated that NOW accounts cost banks and thrifts about 8% per cent in interest and services, which was some 4 percentage points more than the effective cost of demand deposits. But when NOW accounts were extended to the four other New England states in 1976, they were less costly because institutions in those states provided less generous terms. For example, the percentage of banks offering unlimited free NOW account drafts in Massachusetts and New Hampshire was 56 per cent, while in the other four states it was only 21 per cent.

When NOW accounts go nationwide next month, therefore, the effect is likely to be to raise the cost of such checking account balances significantly. The extent of the increase will depend on the terms and conditions offered, but in the present highly competitive environment, it could easily amount to 3 or 4 percentage points. The banks that will be most vulnerable, of course, are those with a high proportion of deposits in household accounts, especially where they face intense local market competition from thrift institutions.

One cannot discuss recent developments in the competition for deposits without mentioning electronic banking. During the 1970s, electronic banking developed more slowly than many had anticipated. But I believe that we can look forward to an increasingly rapid development in this field during the 1980s, now that the trial period is behind us, and aided by the various rights and safeguards recently spelled out in the Electronic Funds Transfer Act.

One EFT device that has been particularly popular with the public is the automatic teller machine, since these machines make it possible to make deposits and withdrawals at any time. The number of ATM's at the end of 1979 was over 14,000, and it is estimated that there may be as many as 125,000 operating in the nation by the end of 1985. Although 90 percent of the ATM's are now located on bank premises, a recent survey showed that one out of four planned installations is scheduled to be located off premises, which has obvious competitive implications. In any event, it is clear that electronic banking has the potential to permit banks to extend their services to customers over a broader geographic area, where legally permitted, and thus to alter significantly the forms of competition for deposits in the years to come.

Interest Rate Developments

A second major challenge to banks, particularly the smaller banks, has been the recent marked increase in interest rate volatility. This year, we have witnessed interest rate fluctuations of unprecedented dimensions, far exceeding the range of expectations of almost all observers. Thus, interest rates rose sharply in the early part of the year to record highs — popularly characterized by a 20 per cent prime rate — dropped precipitously in the spring with the onset of recession and collapse of aggregate credit demand, and then abruptly turned upward again at midyear, with the increase accelerating in recent weeks until rates are again approaching last spring's peak. The effect of these interest rate variations on security prices has been dramatic, to say the least. For example, one long-term government bond, issued in

August 1979, at close to its par value of 100, fell to 82 late last winter, rebounded to a premium of 108 by late spring, and had fallen back again to 84½ early this week.

The full explanation for these extreme swings in interest rates is not entirely clear to me. The shift from economic expansion to sharp recession to an unexpectedly early recovery — and the associated effect on credit demands and investor expectations — provides a good part of the answer. But surely our continued high rate of inflation, and the uncertainties in lender and borrower attitudes that this creates, are also a part of the cause. Indeed, it was the increased uncertainty as to the relationship between interest rates and demands for money and credit that led the Federal Reserve in October 1979 to shift the emphasis in its operations to the provision of the bank reserves thought consistent with monetary aggregate goals, and away from market-oriented interest rate indicators.

Inflation clearly remains our nation's foremost economic problem, and we at the Federal Reserve remain committed to moderating the growth in money and credit as a means of reducing inflationary pressures. Aggregate demand for money and credit is importantly influenced by inflation and inflationary expectations, and thus there is a good chance that such demand will ebb and flow as the battle against inflation is being fought. This being so, it also seems to me a likely prospect that interest rates may continue to show unusual variation, though probably not so much so as during the extraordinary ups and downs of the past year.

It follows that, if there is substantial risk that interest rates in the future may be more volatile than in the past, bankers must adjust their thinking and their operations to this new environment. First, they must realize that it has become extremely hazardous to try to boost earnings by speculating on future interest rate movements. We are all aware of the difficulties that several major banks have encountered because they placed sizable bets on interest rate forecasts that turned out to be wrong.

But banks must go well beyond avoiding outright interest rate speculation. They also must make every effort to reduce the interest rate risk that is inherent in the depository intermediation function. Most important, banks of all sizes need to match closely their interest-sensitive assets and their interest-sensitive liabilities in order to attain a fairly constant net interest margin over wide interest rate ranges. Data at midyear indicated that the the nation's major banks are now balancing their interest-sensitive assets and liabilities relatively well. Smaller banks, however, appear to be having greater problems. Mainly because of the dramatic increase in money market certificates since 1978, small banks in aggregate now have more interest-sensitive liabilities than interest-sensitive assets. Moreover, this gap could widen further for a time, due to the continued strong growth in interest-sensitive liabilities juxtaposed against the relatively heavier portfolio concentration that these small banks have in longer term, fixed-rate municipal bonds and real estate loans.

Given the recent sharp increase in interest-sensitive deposit liabilities, bankers generally are also emphasizing floating rate loans in their new lending activities. This response seems to me appropriate and prudent, since only in this way can they hope to match interest returns against an uncertain cost of funds — thereby stabilizing their earnings and maintaining a high level of bank soundness. At the same time, however, I would caution that a greater reliance on floating rate loans does not remove interest rate risk, but only shifts it more fully to the bank's borrowers. There needs to be a recognition of this risk by bankers and borrowers alike, so that both can determine whether there is likely to be a sufficient margin of assets or revenues to cover unexpected interest rate costs. Very generally, in an inflationary environment it can be expected that borrowers should be able to cover such costs as incomes rise along with prices, but there are bound to be exceptions to this rule.

Banks also are responding to greater interest rate volatility by reducing the average maturity of their investments. This response is not surprising, given the devastating impact that high interest rates have had on the market value of bank investment portfolios. A recent study by Salomon Brothers showed that the depreciation of the investment portfolios of a group of 35 large banking organizations at the end of March amounted to nearly 14 percent of stated book value, and equalled 27 per cent of the equity capital of these organizations. This is a very large interest rate exposure, in view of current uncertainties as to the potential range of rate variation. It must be remembered also that these figures do not reflect the rate exposure usually found in long-term fixed-rate loan portfolios, which by convention are not marked to market.

Another way that banks can protect against interest rate uncertainty is by using financial futures contracts. So far, only a very few banks have entered into these contracts in any volume, although interest in them appears to be spreading quite rapidly. Most banks now utilizing these contracts apparently are attempting to hedge interest rate risks connected mainly with trading account securities and with mortgage commitments entered into at specified interest rates.

For the present, the bank supervisors have mixed emotions regarding bank involvement in financial futures contracts. On the one hand, we recognize that these contracts can help to hedge interest rate risk exposure, if used properly. On the other, we know that these contracts can be — and on several occasions have been — used to engage in outright speculation. The joint policy statement on this subject issued early this year also reflects our concern that some banks, particularly the less sophisticated ones, might enter into these contracts without a clear understanding of their possible implications for the bank's financial condition.

Credit Risk Exposure

A third major challenge to the banking industry, in addition to coping with the high cost of deposit competition and guarding against interest rate risk in an uncertain environment, is that of adjusting to probable changes in credit risk exposure. I have no doubt that credit risk potential is on an upward trend, and that it is likely to be reflected in all major aspects of bank lending activities. But I also believe the problem to be manageable, given careful attention by bankers to the presence of new elements of risk in their credit and lending policy decisions. At least four different areas of credit risk exposure deserve comment.

First, in our national effort to exert the discipline necessary to get inflation under control, it seems quite possible that there may be a rising incidence of financial distress situations. These may develop in various ways. Some borrowers, as I have noted, may not allow for an adequate cushion of income or assets to protect against unexpected increases in borrowing costs, particularly in an era of floating-rate loans. Others, in their financial planning, may have relied unduly on the increasing cash flows produced by inflation to service their obligations; as inflation subsides, so too will the nominal growth in cash flows. And still other borrowers may be counting unduly on strong and growing markets for their products and services; in an economy marked by anti-inflationary restraint, growth expectations based on past performance may well prove for a time to be excessive.

A second area of credit risk is that caused by unexpected external shocks to the economy. The quantum jump in energy prices provides the best example. This increase, necessitated by the developing world shortage in supply as well as by OPEC actions, has dramatically altered factor costs in production and hence the expected profitability of many product lines. Higher energy costs also are bringing important shifts in consumer spending behavior and may well alter tourist travel and vacation patterns. And the high cost of fuel, I believe, is one of the many factors contributing to the disproportionate growth in recent years of the sunbelt versus most of the northern sections of our country. If account is not taken of these changing patterns and trends, excessive commitments could be entered into and bank loan workout problems could multiply.

Foreign lending exposure is another possible problem area, in that the impact of higher petroleum prices is also having a seriously adverse effect on many of the non-oil-producing, less-developed countries. If these countries continue to experience large deficits for an extended period, some could have difficulty servicing their debts. That, of course, would bring the need to renegotiate or reschedule loans from our banks, and to find other means of easing their deficit financing problems.

I hasten to add that-it is very difficult to predict how the LDC debt problem is going to work out over time. Much will depend on the ability of these countries to continue to expand their exports at the rapid pace of recent years. Also important will be their ability to limit imports that are not essential to economic development. And it is not yet clear how large a role the international lending agencies may play over the next several years in helping to finance necessary LDC deficits. But given the uncertainties, the bank supervisory agencies have been stressing that banks should avoid excessive concentrations of credit to individual countries. The rationale for this policy is to encourage banks to position themselves so that they will not be seriously damaged if one or several LDC's should encounter debt servicing problems.

A final area of credit risk that will bear close watching is in consumer lending. Partly this is a matter of the continued squeeze in the household budget positions of many families, reflecting the inflation in energy and other prices and uncertainties as to the prospects for future income growth. But also important is the increase in potential credit risk exposure arising from the new, liberalized personal bankruptcy laws. As you know, Congress recently amended the bankruptcy laws in a manner that has made the filing of bankruptcy by individuals more attractive than formerly. Among other provisions, these amendments allow individuals to retain considerably more personal assets than ever before.

It is still too early to assess the full dimensions of this change on consumer credit loss experience. However, we do know that the number of personal bankruptcies has risen very sharply this year, and there is some concern that filings may continue to expand as more people learn of the more liberal rules. Predictably, banks are already beginning to respond to the new bankruptcy provisions, mainly by tightening consumer lending standards and increasing the cost allowances made for expected credit problems.

Conclusion

In concluding, I would like to focus the discussion briefly on the situation of smaller banks, since these play a major role in financing the agricultural sector of our economy. In the last several years, these banks, too, have been subjected to great changes in their operating environment, and this trend seems bound to continue. Beginning next month, banks and thrift institutions throughout the nation will be able to offer NOW accounts, and this surely will step up competition for deposits now held by small banks. In addition, these banks undoubtedly will continue to see a significant rise in their interest-sensitive liabilities, including money market certificates and $100,000 CD's. The higher and more variable cost of funds will place increasing pressure on small banks to increase their interest-sensitive assets in order to preserve their operating margins in an environment of variable and uncertain interest rate trends. Finally, these banks will have to continue to cope with the additional hazards produced by our persistent problems of inflation and economic instability.

How small banks will fare will depend on whether they choose to compete aggressively for deposits, whether they place greater emphasis on floating-rate loans in order to balance interest-sensitive assets and liabilities, and wheteher they can maintain their credit standards in these difficult and changeable times. So far, many small banks appear to have done quite well in adjusting to their new circumstances. It is particularly encouraging to note that the net income of banks under $100 million was up 15 percent last year, and increased 7 percent further during the first half of 1980. But major challenges still lie ahead for small banks, and for bankers and supervisors alike, it will be important to monitor the developing situation with care and flexibility.