1
The Changing Environment for Banking

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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, partic-