The Changing Banking Scene

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It is always a pleasure for us in the Federal Reserve System to meet with you, the members of the New Jersey Bankers Association, and to share our thoughts on matters of mutual concern.

When I spoke with you here ten years ago, I pointed out that the systems that men create, whether they be economic, social, or political, are designed to meet the needs and aspirations of men. And those needs and aspirations are ever changing.

It is not enough that an institution or system serve those who have a proprietary interest in it. Over the long run a particular institution or system must serve society and meet its changing needs; if the institution or system does not do so, it will perish. History is full of evidence of economic systems, of governmental systems, of social systems that failed in this respect and therefore vanished from the earth. There is nothing sacred about the economic system or the banking system that we know today. Unless they serve society and keep up with its needs they, too, will pass away. Thus, as commercial bankers and as central bankers, we are under continuing pressure to improve the ways in which our organizations serve the people.

In my discussion with you today I propose to comment on two subjects: first, the structure of the banking system, with special reference to New Jersey, and, second, recent Federal Reserve proposals to improve the nation's payments mechanism by speeding up the collection of checks.

BANKING STRUCTURE

Society wants a banking system that provides banking services of wide scope and high quality at reasonable cost, available to all persons who have need for these services. History has demonstrated that competition fosters efficiency by assuring the broad availability of such services at low cost. History, on the other hand, has also taught that unrestrained competition can destroy. Thus, society seeks to promote efficiency and healthy competition.

Much has happened since I commented here a decade ago upon the report of a Branch Banking Study Committee appointed by the Commissioner of Banking and Insurance, and chaired by Professor Chandler of Princeton. The reaction of bankers to the Committee's modest suggestions was cautious—like walking on eggs. But a lot of eggs have been broken since then. Over the last ten years the New Jersey Banking Law has been changed bit by bit.

The most comprehensive changes were made in 1969. The amending statute made three principal changes in the New Jersey Banking Law.

(1) It created three banking districts, and within any district permitted branching and merging by commercial banks and by savings banks,

(2) It eliminated branch-office protection for commercial banks and savings banks in communities having a population of 7,500 or more, and

(3) It authorized the creation of bank holding companies which could operate throughout the state.

Many of the banks in New Jersey responded enthusiastically to the new legislation.

Multibank holding companies were formed to do business throughout the state. Six companies with subsidiaries in more than one district are now in operation. These companies control over three dozen banks[1] with about one third of the commercial bank deposits in the state. In addition, there are at least four or five other banks or one-bank holding companies that appear likely to embark on statewide expansion programs. In the next several years there may be as many as ten or twelve major statewide banking organizations, each having representation in most of the important markets in the state.

At the same time that bank holding companies were establishing their networks across district lines, branching activity within banking districts proceeded at a lively pace. Over two hundred fifty new commercial bank branches and savings bank branches[2] were established between the middle of 1969[3] and the end of 1971.[4] Two thirds of the new branches were established in communities that could not have had such branches under the old law.

In addition to the *de novo* branches, more than forty mergers[5] were consummated during the same period. Much of the branching and merger activity within districts involved subsidiaries of the holding companies that were expanding statewide.

At the Federal Reserve Bank of New York we followed closely the effects of the broadened expansion powers on the competitive banking environment in New Jersey. Last summer we interviewed officers of eighteen commercial banks in northern New Jersey to obtain a better understanding of the ways in which banks initially responded to the 1969 amendments dealing with branch offices.

Many of the bankers with whom we talked criticized the supervisory authorities for permitting too many banking offices, but none of them indicated that their profits had suffered appreciably. We think that in general the expansion of banking offices between mid-1969 and the end of 1971 was orderly. Most of the new offices were established in fast-growing communities capable of supporting additional facilities.

NEW COMPETITION. Bankers establishing branches in previously protected communities made strong efforts to obtain accounts. They spoke personally with potential customers and sought aggressively to obtain the accounts of newcomers to the community. They were eager to serve their new customers well and to provide services that previously had been unavailable in the community. Many provided expanded evening banking hours. Most changes, of course, were subtle and difficult to evaluate.

We found that bankers in communities that lost protection soon became keenly aware of the presence of the new banking offices. They took affirmative steps to improve their services and to establish a closer identity with their communities. They made a conscious effort to develop a more personal rapport with their customers and to speed up the execution of services. They sought to modernize and expand their banking offices, as, for example, by installing drive-in windows and providing parking space for customers. A few banks raised the rates of interest paid on savings deposits to be more competitive with new banking offices in the area.

It is not clear, of course, that every new service will be continued indefinitely. Nevertheless, we concluded from our discussion with the bankers that many of these new developments probably would not have occurred if there had not been a change in the banking law. The public has benefited from the new banking competition introduced into many communities for the first time. Both consumers and business concerns in those communities now have a wider choice of banking options and a broader range of banking services than were ever available to them in the past. Vigorous competition is the best safeguard the public has that it will receive high-quality service at the lowest cost.

As you know, the Banking Committee of the New Jersey General Assembly recently reported out a bill[6] that would permit statewide branching, eliminate branch-office protection, and reduce home-office protection. The key feature of this bill is the removal of banking-office protection from cities and important suburban growth areas. For a long time, banks in these communities have been insulated from competitive forces. Lifting protection can be expected to promote significant new branching activity along the lines observed following the 1969 amendments.

In considering this proposal and, indeed, any other

[1] Thirty-nine banks.

[2] Two hundred thirty-two new commercial bank branches and twenty savings bank branches.

[3] The change in the law regarding branches became effective July 17, 1969.

[4] During the period the number of banking offices in the state increased by 25 percent.

[5] Forty mergers of commercial banks and one savings bank merger.

[6] Assembly, No. 706 Committee Substitute. On May 18, 1972 the bill was passed by the General Assembly and transmitted to the Senate.

proposals to amend the banking laws, it is well to bear in mind that the public is best served by well-managed banking organizations offering diverse services, provided there are sufficient alternatives in each banking market to assure a healthy competitive environment. In my view, statewide branching and further curtailment of home- and branch-office protection would promote this goal. I do not suggest that large banking organizations should, or will, come to dominate the state and swamp local institutions. Indeed, recent experience in New Jersey and in other states has shown that competently managed and conveniently located small, independent banks can thrive alongside branch banks.

BANKING EXPANSION IN THE NATION. The 1969 amendments to the New Jersey Banking Law and the proposed legislation now being considered by the Legislature are not isolated developments, nor are they events unique to New Jersey. Indeed, these changes may be viewed as part of a movement in many parts of the nation to permit the expansion by banks into wider geographic areas.

In recent years, a number of states have liberalized their traditional branching restrictions; New York is an example.

At the same time there has been a rapid expansion of multibank holding companies in many states across the nation. Much of the expansion has been spurred by the 1970 amendments to the Federal Bank Holding Company Act of 1956. The amendments called for equal regulatory treatment for all bank holding companies, whether one-bank or multibank. As a result, many one-bank holding companies which might have been reluctant to become multibank holding companies prior to the 1970 amendments have recently established new banks or acquired existing banks.

The amended Bank Holding Company Act permits bank holding companies to expand the nature of their operations as well as their geographic coverage; bank holding companies are permitted to enter into bank-related activities anywhere. Bank holding companies have acquired mortgage companies and other financial concerns in distant places. Thus, interstate expansion by bank holding companies has already gathered considerable momentum. As these organizations continue to establish or acquire nonbanking subsidiaries across state lines and serve customers in distant localities, as I expect they will, state lines will have less significance in the banking industry.

I do not intend to suggest, however, that the bank expansion movement has been greeted with enthusiasm in all parts of the country. To the contrary: several states have imposed new restrictions on the entry into those states by bank holding companies organized elsewhere. On balance, however, I believe that most changes at the state level have been in the direction of more liberalized rather than more restricted expansion powers. There is little doubt that the nation's banking institutions have been eager to expand their frontiers, not only geographically but also functionally.

The expansion of banking institutions into new geographic areas and into new bank-related activities has, of course, increased the burden on the bank supervisory authorities, both state and Federal. As individual banking organizations continue to test and probe their new freedoms, they will be entering markets heretofore protected from entry. While such expansion will indeed create new possibilities for a more vigorous competitive environment, the need to protect the public interest will become increasingly crucial. Perhaps more than ever before, it will be incumbent upon the supervisory agencies to prevent the elimination of significant and viable competitive alternatives, to ensure that the largest banking organizations do not attain a position of dominance in local markets, and to preserve opportunities for new entry.

The Federal Reserve System has been and will continue to be responsive to, and mindful of, these considerations. What then can I offer in the way of advice to New Jersey bankers who are contemplating taking advantage of the new branching, merging, and holding company powers? I would make two suggestions. First, I think you would benefit by reviewing the antitrust decisions of the courts, the opinions of the Justice Department, and recent rulings of the Federal Reserve Board regarding bank mergers and the acquisition by holding companies of bank and nonbank subsidiaries. Second, I recommend that you come into the Reserve Bank and discuss your expansion plans with the Reserve Bank officers.

IMPROVEMENTS IN PAYMENTS MECHANISM

On March 28, 1972, the Federal Reserve Board published for comment proposed changes in its Regulations D and J to make reserve requirements of member banks and Federal Reserve check-collection procedures more equitable and more efficient. I want to talk about the proposed changes in Regulation J, especially the requirement that a commercial bank pay in immediately available funds on the day of presentment for the cash letters it receives from a Reserve Bank. But first, a bit of background.

In the first decade of this century, before the enactment of the Federal Reserve Act, checks were collected in far too many instances by elaborately circuitous routing in attempts to avoid or reduce so-called exchange charges.

There were inordinate delays before the payee of a check received good payment; and long delays in the return of unpaid items made the circuitous routing even worse. In establishing the Federal Reserve System, the Congress expected that it would serve to improve the check-collection system; such improvement would be facilitated because many banks would have balances at the Reserve Banks to which payments could be readily debited and credited. The newly created Federal Reserve Banks soon established an Interdistrict Settlement Fund so that they could make payments on behalf of member banks through other Federal Reserve Banks to the banks in their Districts.

With advancing technology in air transportation and electronic communications, the Federal Reserve Banks have been able to reduce markedly the time required for the collection of checks and to expand their capabilities for wire transfer of bank balances and Government securities.

Last year the Federal Reserve Banks collected more than eight billion checks worth almost $4 trillion, and transferred by wire more than $13 trillion. In short, a great deal has been done, but it is also clear that much remains to be done.

In 1969, the Federal Reserve System established a Steering Committee on Improving the Payments Mechanism; its membership is drawn from members of the Board and representatives of the Reserve Banks. I am a member of that committee, whose studies, plans, and policy decisions have been supported by a broad range of communications specialists, economists, lawyers, and check-collection officers. The committee has sought, in cooperation with the commercial banks, to improve the payments mechanism in various ways, e.g., by expanding same-day payment arrangements in large metropolitan areas, by liberalizing access to the Federal Reserve wire network for the transfer of funds, and by improving transportation facilities for the movement of checks. At the same time the commercial banks have been involved in a number of projects having similar goals.

DIRECTION OF IMPROVEMENTS. Indications of the direction in which the payments services of banks should move have come from the MAPS study[7] of the American Bankers Association; the six-volume report of the so-called Atlanta study[8] (another cooperative endeavor of commercial banks and the Federal Reserve); the research of the SCOPE committees[9] around the country; the experiments with point-of-sale terminals linked to bank computers now going on in Columbus, Ohio, and Hempstead, New York; the development of the CHIPS and PEPS arrangements[10] in New York City; and the establishment of regional check processing centers. This list is by no means a complete catalog of recent studies and accomplishments.

What the list does make clear, however, is the direction in which the banking system is moving, and that it is now moving at an accelerating pace. All bankers will have to give increasing attention to how their banks can best accommodate themselves to the changing procedures and technology in order to meet the needs and desires of their customers in a competitive market. The direction we're going, it seems to me, is toward greater use of electronic means of payment, including, among other methods, the Federal Reserve wire network, the Bank Wire, card-activated terminals, exchange of magnetic tape (with or without checks), and magnetic tape input for the deposit of large payrolls.

Despite the numerous studies and experiments now under way with electronic means of payment, however, we are not on the threshold of a checkless era. The Atlanta study, the most exhaustive yet made, suggests that, even if payroll deposits, payments of recurring bills, and point-of-sale terminals are successfully introduced in the next few years, all that will have been done by 1980 is to hold the volume of checks at about its present level. So, we're going to have to handle a large number of checks for quite a while.

PROPOSED REVISION OF REGULATION J. Now, let's return to the proposed revision of Regulation J to require payment in immediately available funds on the day of presentment. This proposal is another step in the continuing process of improving the country's payments mechanism. An estimated 85 percent of the dollar value of all checks is in fact now paid on the day of presentment.

[7] Executive Report of the Monetary and Payments System Planning Committee published by the American Bankers Association, April 1971.

[8] *Research on Improvements of the Payments Mechanism: Phase III General Systems Design and Analysis of an Electronic Funds Transfer System*, Prepared for the Federal Reserve Bank of Atlanta by Atlanta Payments Project (Atlanta, Georgia: Georgia Institute of Technology, March 1972).

[9] Special Committee on Paperless Entries.

[10] Clearing House Interbank Payments System and Payment Exchange Paper System.

The remaining 15 percent represents largely items drawn on "country" banks not participating in any clearing house or similar arrangement for exchange of items.

It is estimated that the proposal, when effective, would reduce Federal Reserve float by about $2 billion, thus cutting banks' reserves by the same amount. It is for this reason that the proposed change in Regulation J is coupled with a proposal to revise Regulation D, governing member bank reserve requirements, which would lower the presently required reserves by almost $3 billion.

However, the effects of these two changes would not be the same for all banks, since banks differ widely both in net demand deposits subject to reserve requirements and in size of cash letters received each day. In order for you —and for us at the Fed—to reach a better estimate of just how the proposed change in Regulation J would affect individual banks, we have asked you to complete a one-page form. An analysis of the responses, which I am gratified to report have already been filed by more than half of the banks, shows wide variations from net gains in lendable or investable funds to several fairly significant reductions. The information provided in your responses will, of course, be studied carefully by the Federal Reserve as it gives further consideration to the proposed amendments of the Regulations.

RCPCs. Another important step in improving the payments mechanism is the establishment of what are called Regional Check Processing Centers, or RCPCs. Here in New Jersey, as many of you know, the Federal Reserve Bank of Philadelphia is planning to establish such a center at its premises in Philadelphia to speed up the collection of checks which are drawn on a bank in the Third Federal Reserve District and which are deposited in another bank in the same area. The Philadelphia Reserve Bank will receive such checks from the depositing bank late in the day, sort the checks during the night, and deliver them in the morning to the drawee bank for provisional payment that day in immediately available funds.

The Federal Reserve Bank of New York has been having discussions with the banks in that part of New Jersey which is included in the Second Federal Reserve District about the expansion of the Bergen County Clearing Bureau that now serves banks in six counties. The Bureau, which has been in existence for the last thirteen years, is to be converted into a Federal Reserve facility to speed up the collection of checks in northern New Jersey, as the Philadelphia Reserve Bank will do in the southern counties.

Once again, as you know, we have sought your help, which has been given freely, in analyzing the contents of your cash letters. From an analysis of the flows of checks we are now trying to establish the best location for the Northern New Jersey Regional Check Processing Center, a site that will serve you and us most efficiently in terms of transportation times and costs, and the latest possible hour for depositing work. Incidentally, you may be interested to know that our preliminary estimate is that the Center will process a million or more checks a night when it is fully operational, we hope, in a year or so. That volume would be exceeded by only eight or nine Federal Reserve offices so that, you see, it will not only be a considerable undertaking, but one that will benefit a great many checking account holders in this state.

CONCLUSION

In conclusion, I believe that the developments that I have been discussing with you demonstrate the dynamic nature of banking. Improved service to the public has been the goal. Competition has an important role in implementing that goal. As the banking system improves its service to the public, its importance will increase, and well-run banks concerned with serving society should prosper.