

# THE FINANCIAL SERVICES INDUSTRY: RECENT TRENDS AND FUTURE PROSPECTS

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The financial history of the United States is a story of recurring change in response to economic, political, and demographic forces. These changes, however, have not occurred at a constant, steady pace. Relatively short periods of very rapid change have been followed by long periods of slow evolutionary growth. Some changes have resulted in a fundamental alteration of the financial system while others have been of only transitory significance. Thus, it is not always easy to spot significant changes when they are taking place, and it may be equally difficult to correctly assess the impact of ongoing changes on the future development of the financial system.

Nevertheless, some of the developments in recent years clearly suggest the emergence of trends that could profoundly alter the financial system over the next quarter century. There have been a number of these trend indicators but it is convenient to classify them under a few general headings. These include (1) a significant change in regulatory philosophy, (2) imaginative innovation on the part of financial entrepreneurs, and (3) technological developments, especially in the area of computerized processing and communication of financial data. It is obvious, however, that developments in these several areas have not been independent of one another. Regulatory practices, for example, have at times stimulated innovation in the financial industry. At other times, innovation has encouraged changes in regulatory practices.

**Regulatory Policy** The philosophy that dominated the activities of Federal regulatory agencies until fairly recently grew out of the developments in the early decades of this century. Partly as a result of competition between state and Federal agencies in the chartering of new banks, the number of banks in the United States rose from about 13,000 in 1900 to almost 31,000 in 1920. More than three-quarters of the new banks were small, state-chartered institutions with a minimum of capital. Moreover, many of them were highly dependent on the health of a single industry, such that when the industry experienced hard times so did the dependent banks. Some

sectors of the economy, notably agriculture, did experience hard times in the 1920's and by 1928 the number of banks had been reduced by some 4,500. Shortly thereafter, the onset of the Great Depression brought on the virtual collapse of the banking system, with the total number of banks in the United States falling by more than 11,000 between mid-1928 and mid-1933. As the depression deepened the nonbank portion of the financial system and much of the non-financial economy collapsed along with the banking system.

When the Roosevelt administration took office in early 1933, financial reform was the centerpiece of a program to bring about economic recovery. Numerous proposals for the reform of all types of financial institutions were submitted to an eager Congress that quickly enacted them into law. The result was the most far-reaching change in the body of laws regulating U. S. financial institutions that has ever occurred in a comparable period of time. In view of the conditions that existed at the time, it is not surprising that protecting the safety of financial institutions was one of the paramount objectives of this legislation. New agencies were set up to insure deposits in financial institutions and to supervise these institutions. At the same time the powers of some existing agencies, such as the Federal Reserve System, were greatly strengthened. Moreover, laws were passed that limited competition among financial institutions, both among institutions of a particular type as well as between different types of institutions.

For the next forty years the financial industry remained one of the most tightly regulated industries in the U. S. economy. The emphasis on "Safety First" that was born in the depression of the 1930's became the guiding philosophy of the regulatory agencies. Few would disagree that these agencies have been successful in protecting the soundness of the financial system, for over the past thirty years the number of financial institutions failing each year has been extremely small. This low failure rate, however, has not been achieved without cost. In particular, the increased safety involved a cost in the form of reduced competition.

Some of the regulatory devices that limited competition among financial institutions include:

1. Barriers to entry that have limited the number of competitors in a particular type of activity.

2. A strict segmentation of the financial industry, with many institutions limited to a rather narrow range of activity. Although commercial banks are permitted much more latitude than most other institutions, they are not allowed to engage in such activities as investment banking. The activity of savings and loan associations, credit unions, and most other financial institutions, have been quite narrowly circumscribed.

3. Prohibition of interest on demand deposits and interest ceilings on time and savings deposits.

4. Limitations on branching. Commercial banks cannot branch across state lines and branching within states is controlled by state law. Some states prohibit any branching by commercial banks.

The preceding are some of the more important devices that have been used to limit competition in financial markets. They are indicative of the types of restraint that have been imposed on financial institutions for what was thought to be their (and the public's) own good.

All of the foregoing barriers to competition still exist, but in recent years there has been a significant shift in the attitudes and philosophy of regulatory bodies. This change has come about partly as a result of imaginative innovation on the part of the financial industry and partly from a recognition by legislators and regulators of the costs involved in restrictions on competition. The soundness of the financial system remains the most important objective of the supervisory agencies, of course, but it is no longer the only objective. Regulators and legislators alike have recognized the trade-off between safety and competition and in the last decade or so they have chosen to move slightly away from the goal of absolute safety in favor of some additional competition. Moreover, in the last decade more and more of the time and energies of the regulators have been devoted to implementing the consumer protection and equal rights laws enacted by Congress.

**Industry Innovation** In recent years intense competition in financial markets accompanied by a rising interest rate structure stimulated a number of innovative actions by financial entrepreneurs that brought into being many new financial instruments

and new services to the public. At the same time, some of these changes had the effect of blurring the sharp distinction between different types of financial institutions and erasing some of the lines that have traditionally separated one kind of financial institution from another.

Pressures against the control of interest rates on deposits began as long ago as the early 1960's. At that time commercial banks began to issue large denomination certificates of deposit (CD), a device that enabled them to compete for funds in the national money markets. The CD was followed by a series of similar instruments in the 1960's, until the authorities recognized the futility of trying to prevent banks from raising funds in the money markets. Interest on deposits is still regulated, of course, but recent developments point toward the eventual elimination of such controls. Banks and S&L's are now permitted to pay somewhat competitive rates for funds through the issuance of so-called money market certificates, and the introduction of negotiable order of withdrawal (NOW) accounts in some states by savings and loan associations and mutual savings banks, share drafts by credit unions, and automatic transfer services by commercial banks in effect permit the payment of interest on demand deposits. Legislation has been introduced in Congress that would permit, over a period of time, all deposit interest rates to rise to market levels and permit all federally insured institutions to offer interest-bearing transactions accounts to individuals.

At the same time, banks and thrift institutions are expanding the scope of their activities. In many states thrift institutions are beginning to make consumer loans, and credit unions are offering longer term loans, even mortgage loans in some instances. The legislation being considered by Congress also provides that federally insured institutions shall be permitted to hold up to ten percent of their assets in the form of consumer loans, commercial paper, corporate debt securities, and bankers acceptances. The legislation also would give Federal savings and loan associations the ability to offer trust services on the same basis as national banks. A report of the Committee on Banking, Housing, and Urban Affairs of the U. S. Senate states that "The FHLBB is expected by regulation to tailor permissible trust powers to those that enhance the ability of thrifts to offer complete financial service to the consumers."<sup>1</sup>

<sup>1</sup> U. S., Congress, Senate, Committee on Banking, Housing, and Urban Affairs, S. Rept. 96-368 to Accompany H. R. 4986, 96th Cong., 1st sess., 1979, p. 13.

In short, these nonbank financial institutions that provide services primarily to consumers are becoming more and more like each other and are coming more and more to resemble commercial banks. Commercial banks, for their part, have expanded the scope of their activities, especially through the formation of holding companies. Although the activities of bank holding companies are restricted by law to certain areas closely related to banking, the holding company device has enabled banks to enter several areas that had heretofore been closed to them. In addition, in recent years there has been growing sentiment in favor of allowing banks to engage in investment banking activity, especially in the direct placement of securities.

Finally, it appears likely that barriers to bank branching across state lines will be eased in the not too distant future. A major review by the Treasury Department of the McFadden Act and the Douglas Amendment to the Bank Holding Company Act was mandated by the International Banking Act of 1978. It is widely anticipated that this study, when completed, will endorse multi-state branching. The holding company device permits banking organizations to carry on some activities across state lines already, and of course, much commercial lending is done in regional and national markets. The pressures to permit financial institutions located in multi-state metropolitan areas to operate offices in more than one state have been especially strong. The Federal Home Loan Bank Board, for example, recently proposed branching throughout the District of Columbia Standard Metropolitan Statistical Area. Finally, the continuing application of electronic technology to banking may provide the final push toward multi-state branching.

**Technological Change** The continuing changes brought about by competitive pressures and modifications in the regulatory environment will play an important role in determining the nature of the financial system of the future. Another major determinant undoubtedly will be the technological innovations that have been occurring at an ever-increasing pace in recent years. Regarding technological change, the most important innovation in the financial area was the development of computer and communications systems for transferring bits of information from one place to another by electronic means, and the application of these systems to the payments mechanism. The result is what is commonly referred to as an electronic funds transfer system (EFTS).

The subject of EFTS is a popular one these days, but it is one that should be approached with some caution. Simply because the potential for radical change represented by EFTS is so great, it is easy to overstate its importance for the near future. The temptation is to look at what is technologically possible with existing equipment and project all sorts of pie-in-the-sky developments in the relatively near future. While there is little question about the potential for change in EFTS, experience over the past decade indicates that progress toward realization of the full potential of EFTS may be slow. For while there are strong pressures toward development of EFTS capabilities, there are also important barriers to the adoption of certain aspects of the system. The actual rate of progress in the years ahead will be determined by the relative strengths of these conflicting pressures.

The immediate impact of EFTS will be on the way banks perform traditional services rather than on the provision of new services. The impact on payments services will be especially great. Since World War II, growth in the use of bank services, especially payments services, has been tremendous. It is estimated that more than 30 billion checks are written each year and the number is increasing at about seven percent per year. Needless to say, the cost of processing and moving this mountain of paper has been mounting accordingly. It is little wonder that the banks and the Federal Reserve System have had to turn more and more to the use of computers to get the job done. The next step would appear to be the use of modern technology to eliminate most of the checks.

The technology exists to permit revolutionary changes in the way financial services are provided, but the full potential of an EFT system is still a long way from being realized. Nevertheless, a number of important elements of such a system have been introduced. A large number of banks in urban areas have introduced automated teller machines, some of which are on-line to the banks' computers. These machines are capable of performing many of the routine tasks of a human teller and they are on duty 24 hours a day. Customers can obtain cash from the machines, transfer funds from one account to another, make loan payments, and request information as to the current status of a particular account. Some financial institutions are beginning to locate automated teller machines in stores and supermarkets. Employees may be on hand during the busiest hours of the day to take care of transactions the machine cannot handle, and at other times the machines are

available anytime the store is open. These facilities, of course, will reduce the need for traditional branches and may revolutionize the banking structure in the United States.

One of the innovations most often discussed, perhaps, is the point of sale terminal (POS). Located in stores and other business establishments, these terminals are on-line to a bank's computer. By use of a "debit card," the customer is able to make instant payment for goods purchased, or the customer may use a credit card and make payment through the extension of credit by the bank. The terminals may also be used to verify a customer's check. Thus far the reception of the POS terminals has been somewhat mixed. While some of these facilities have enjoyed success, a number have been discontinued because of lack of interest on the part of the public. A feature of these transactions that discourages public acceptance is the immediate debit to the customer's account that eliminates the float associated with check payment.

Many observers feel that the development of the automated clearing house (ACH) in regional financial markets represents an important step toward an effective EFT system. At the present time more than 10,000 financial institutions are participating in regional ACH's and since 1978 the regional organizations have been linked together into the National Automated Clearing House Association. So far, however, the actual functions performed by the ACH's are rather limited, with the handling of payrolls an important one. In processing a payroll through an ACH, an employer delivers a computer tape to his bank containing payroll information for his employees. By use of the tape, the employer's account at the bank is reduced and the employees' accounts at various banks in the clearing house association are increased. The important thing is that not a single check has to be processed. The federal government is the largest user of the ACH's at the present time with the direct deposit of social security payments and other federal disbursements. This not only reduces the number of checks in the banking system, it also greatly reduces the risk of having checks lost or stolen. However, serious questions of computer fraud and consumer privacy remain as barriers to customer acceptance of this system.

Check truncation is also receiving attention as an adjunct to the ACH. Under this procedure, the first bank receiving a check holds it and forwards the information on the check by electronic means to the bank on which the check is drawn. There are various means of forwarding this information, of course, but

one of the more interesting involves the transmission of the image of the check. The potential benefits of check truncation as a means of reducing the volume of checks flowing through the banking system are obvious, but some formidable obstacles must be overcome before this procedure becomes widespread.

How important are these technological innovations for the future development of the financial services industry? This is a difficult question to answer, but what is clear is that the changes described here are little more than the first tentative steps toward what could become a fully functioning electronic funds transfer system. It seems likely, however, that progress toward such a system may be very slow. More than thirteen years ago an article appeared in this publication entitled "The Giro, the Computer, and the Checkless Society." That article attempted to show that computers could be combined with the principles of the giro systems that have existed in Europe for many years to produce a payments system that could function without the use of checks. While the article recognized some of the obstacles to the achievement of such a system, progress has been much slower than was anticipated at that time. Several factors have retarded progress toward a checkless payments system, but by and large the absence of adequate technology has not been one of them. The basic technology needed for an EFTS has existed for some time and the unit costs of performing certain basic functions have fallen sharply over the last several decades.

The most important obstacle to the more rapid development of an EFTS has been the reluctance of the public to accept the new services. Most of the EFT systems that have been developed have certain features that are undesirable to the consumer. As mentioned earlier, the POS system involves the loss of float to the consumer. Automatic deposit of payrolls and other payments may allow fraud and violations of privacy, while the use of several of these systems may result in the loss of a legal receipt in the form of a cancelled check.

Thus far, consumers have had little economic incentive to give up checks in favor of an EFTS. For one thing, they are not presently required to pay the full costs of operating the payments system. Both the Federal Reserve and, perhaps to a lesser degree the commercial banks, subsidize the check processing system. It appears likely that the Federal Reserve System will soon begin to charge commercial banks the full costs of services provided, including check collection services. It will probably be necessary for the banks to pass these costs along to consumers to-

gether with that portion of such costs presently being absorbed by the banks. So the cost to consumers of using checks in the payment process is likely to rise in the not too distant future. The unit costs of EFTS transactions are fairly high at present, but there are at least two reasons to believe that these unit costs will fall quite rapidly as the EFTS becomes more widely used. First, an EFT system involves large fixed costs in the form of investment in capital equipment, but relatively small variable costs. Thus, as volume rises unit cost per transaction should fall quite rapidly. In contrast, a check-based payments system is quite labor intensive, so that variable costs are a large part of total costs. As volume increases, therefore, marginal costs tend to remain high. Second, technological improvements have occurred at an extraordinary pace in recent years. As a result, the cost of processing a single piece of data through a computer, for example, has fallen dramatically in the past two decades. It is doubtful that the possibilities for improvement in these areas have been exhausted, so continued reductions in equipment costs can be anticipated.

The major argument in favor of an EFT system, therefore, is that it holds the potential for increasing the efficiency of the payments mechanism and thereby reducing the unit operating costs. If financial institutions, including the Federal Reserve System, adopt a full-cost-pricing approach for payments services the greater efficiency of the EFTS will be reflected directly in the customer's transactions costs. Such a financial incentive may be more than enough to offset some of the objections to EFTS noted earlier.

**Prospects For The Future** Concrete changes growing out of the developments described in this article have been fairly slow in coming, but they are not insignificant. The least impressive phase of any process of change consists of the construction of an underlying groundwork that will permit and encourage further change. Developments over the past decades have provided such a groundwork and now the process of change appears to be gaining speed. But what does this process portend for the future? How will the financial services industry twenty-five years from now differ from that of today? Lacking clairvoyance, no one can be certain about things that far in the future, but the basic trend indicators discussed in this article suggest some of the things one can look for:

1. Financial service institutions will probably become more homogeneous. This does not mean that

all of these institutions will become identical. Indeed, one would expect some specialization to remain, with commercial banks continuing to emphasize business loans, savings and loan institutions and mutual savings banks holding a large proportion of their assets in mortgage loans, and credit unions making mainly consumer loans. Nevertheless, most of these institutions will look more like each other than they do today, especially those servicing the consumer sector. Some very large commercial banks may become even more highly specialized than they are now, providing financial services almost exclusively to business customers. These institutions may differ more from small banks than the small banks differ from nonbank financial institutions that serve consumers. The very large banks may also provide investment banking services. Thrift institutions and credit unions will differ from those of today primarily by virtue of a more diversified asset structure. Thrifts, for example, will be much more heavily involved in consumer financing than today and they may also be making loans to businesses. To the extent that institutions servicing the public become more alike, provisions of the law favoring certain types of institutions will be eliminated.

2. The several federal regulatory agencies probably will be combined into a single agency that also provides deposit insurance. Regulation in the traditional sense will be much less restrictive than in the past. Regulation of rates paid on deposits will have been eliminated, restrictions on branching will have been eased or eliminated, and many of the rules and regulations designed to protect financial institutions from competition will no longer exist. What might be called consumerist regulation and regulation to ensure equal access to credit, on the other hand, will be much more pervasive.

3. With the changes in the regulatory environment and the tendency of financial institutions to become more alike, competition should be quite intense over the next several decades. This could result in what might be described as a "shakedown" period during which some institutions may be eliminated by merger, holding company acquisition, or in a few instances, failure. At any rate, the total number of financial institutions serving the consuming public should not be much larger, and might be much smaller, than that of today.

4. The ordinary consumer will rarely find it necessary to visit his bank or thrift institution. Most routine transactions will be handled by machine from

remote facilities located in homes or in shops. Trips to a financial institution will be limited to special occasions involving such things as financial counseling, but even that may be done from the home. Banks and other financial institutions will need fewer branches as we know them today, with greatly ex-

panded automated teller machines located in shopping centers replacing many of today's branches. As a result, consumer banking will be much less labor intensive than it is today. Most of the routine transactions will be automated, with the customer in many instances doing most of the work.

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