1-1-1980

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Working Paper 80-123*

by

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It is clearly important to anticipate the environment in which commercial banks will make funds management decisions during the next several years. It is, of course, impossible to predict accurately all aspects of the future environment for funds management decisions; however, we can make some reasonable inferences about the future environment from economic trends, recent legislation, and developments in the banking industry. The discussion is divided into three parts -- the economic environment, the regulatory environment, and trends in the banking industry.

The Economic Environment

The economic environment promises to be challenging for bank funds managers. It appears likely funds management decisions for the next few years will have to be made in an environment of slow real economic growth and rapid (probably double-digit) inflation. The primary causes of slow real growth include the low (relative to other developed western economies) capital base of our economy and the limited probability of productivity gains. While positive changes in public and private policies may improve the rate of real growth, it will take a long time to achieve significant improvement.

Continuing inflation may be cause for even greater concern for bank funds managers. Chart 1, which traces the rates of change for the Consumer Price Index over five-year periods, clearly illustrates the increasing rates of inflation in recent years. Chart 2 shows the rates of change in the Consumer Price Index for six-month periods. This chart illustrates that the rate of inflation has varied cyclically with higher peaks and higher troughs in each ensuing cycle. Six-month rates of change were in double digits throughout 1979 and 1980. Progress in reducing the rate of inflation appears likely to be slow, for more and more of our economic activity is indexed to price increases. A balanced Federal budget appears to be an illusory target. Prices in key areas, such as food and oil, appear likely to be under price pressures for the next few years. Finally, our primary hope for reduced inflation -- rational monetary policy -- seems likely to take several years to achieve significant results.

Two other elements of the coming American economic environment, high interest rates and fluctuating interest rates, appear likely to challenge bank funds managers in the next several years. Charts 1 and 2 illustrate the high correlation between interest rates and the rate of inflation. Numerous studies have concluded that longer-term interest rates tend to exceed the expected rate of inflation by two to three percent. Thus, a prediction of continued high levels of interest rates -- as high or higher than in 1979 -- is consistent with our inflationary expectations.

Wide and rapid fluctuation in interest rates also seems very likely in the early 1980's. The increasing amplitude of interest rate fluctuations can be seen by observing the wide fluctuations in the rate on four- to six-month prime commercial paper in Chart 2 and by following data on changes in the prime lending rates charged by commercial banks:

Years	Number of Changes
1950-54	6
1955-59	10
1960-64	1
1965-69	15
1970-74	65
1975-79	74
1980 (10 months)	39

The above data understate the magnitude of changes in the prime rate because changes were usually one-quarter of a percent prior to the late 1970's, while many prime rate changes in 1979 and 1980 have been one-half or a full percent.

Continuation of these rapid and wide fluctuations in interest rates seems likely if the Federal Reserve sticks to its October 6, 1979 declaration. In essence, the Fed said it will place more emphasis on controlling reserves and monetary aggregates and will let interest rates seek their market levels consistent with reserve and monetary goals. The prime rate was 12 percent on October 6, 1979, and 18 percent a little over a year later. During that year, however, prime has risen to 20 percent, fallen to 11 percent, then risen back to 18 percent. Since the rates discussed are increasingly representative of the borrowing and lending rates on many bank liabilities and assets, funds management at a bank is likely to become increasingly challenging.

The Regulatory Environment

Passage of HR 4986, the Depository Institutions Deregulation and Monetary Control Act of 1980, on March 31, 1980 will probably lead to greater changes in bank funds management than any legislation since the 1930's. The act includes nine titles on far-reaching and diverse subjects including monetary control and reserve requirements, a phaseout of deposit interest-rate ceilings, nationwide authorization of NOW accounts, expanded asset and liability powers for thrift institutions, fees for services provided by the Federal Reserve, preemption of state usury laws, and simplification of truth-in-lending. The purpose in this paper is to describe the primary ways the Act will affect funds management in coming years.

Table 1 summarizes the primary immediate and longer-run impact on funds management of the Depository Institutions Deregulation and Monetary Control Act of 1980. The primary objective of standardization and broader applicability of reserve requirements is better control of the money supply. The lower percentage requirements applied to more banks and the greater limitation in the types of deposits covered means most banks will have increased earning assets and, ceteris paribus, increased earnings as a result of this stairstep change which will be completed for banks and thrift institutions by 1988. A small number of banks, and most thrift institutions, will have higher reserves, which will reduce earning assets and hurt earnings. Longer-run funds management effects will probably include a more equitable competitive environment and decreased variation of relative growth rates among various types of deposits. The Federal Reserve still will not pay interest on reserves left with it; however, the door for that was partially opened. The Federal Reserve can pay a return up to what its securities portfolio earned during the previous calender quarter on accounts above required reserves and on the special supplemental required reserves (the maximum allowed is 4 percent of transaction accounts) the Federal Reserve is permitted to impose under certain situations.

HR 4986 required the Federal Reserve to price its services, such as check-clearing and collection, settlement, wire transfer, and float, at their estimated full cost plus a mark-up so that the resulting prices would be similar to those charged by private business. When the Fed's prices become effective in 1981, banks will have to pay increased explicit cost to the Fed for services. While there is some chance that the demand for Federal Reserve services will rise because more bank and thrift institutions may use them, in my opinion most banks will seek other sources which will provide the needed services in a more efficient (i.e., less costly) manner. The longer-run effects of Federal Reserve pricing will probably include: changes in "cash management" practices of banks; further reduction in bank and Federal Reserve float; greater reliance by correspondent banks on explicit pricing than on balances; and realistic bank pricing of retail transaction deposit services. I also believe that Federal Reserve pricing will provide additional stimulus to electronic banking, i.e., debit cards, direct deposits, ATM's, POS's, etc.

The approval for NOW accounts nationwide, which is effective at the beginning of 1981, will lead to higher interest expense for transaction-type deposits. Higher interest expenses may particularly hurt smaller, retailed-oriented banks whose profitability has been more dependent on having substantial amounts in low-cost demand deposits. In addition, the reserves on savings accounts that are switched to NOW accounts will be twelve percent for the transaction accounts rather than three percent for savings accounts. Nevertheless, in the longer run, NOW accounts also offer positive opportunities to bank funds management. Personal transaction balances should be higher and more stable, and there should be fewer unwanted returned checks and overdrafts. NOW accounts may be the forerunner of one-account banking. Setting the appropriate levels for NOW-pricing factors, such as minimum balances and any fee and service charges, will be an important funds management decision in the 1980's.

The gradual phase-out of Regulation Q ceilings, if completed in 1986 according to schedule, will probably have the most far-reaching effect on bank funds management. There will probably be a gradual increase in the interest cost of many types of bank funds, and there will be increased pressures on bank margins. The impact will be greatest on many retail banks, which will find the maximum interest they can pay on nearly all of their bank deposits, including NOW accounts, rising regularly. Intense competition from other banks and thrifts and predicted high interest rates in the economy are likely to keep most banks at these maximums. Furthermore, competition on the lending side is likely to keep most banks from maintaining their interest margins. As time passes, the emphasis in funds acquisition is likely to shift from quantity to product design and pricing. There will probably be less variation in the relative size and growth of various types of deposits and emphasis on explicit interest rather than on premiums.

Several other parts of HR 4986 will also affect bank funds management in coming years. The increase in insurance of private deposits from $40,000 to $100,000 will mean higher insurance fees, but should enable banks to better distinguish their deposit products from competing nonbank products. Expanded deposit and lending powers for thrifts should increase competition for obtaining and profitably using bank funds. The interest spread between attracting and employing funds may narrow; however, banks have several key advantages, such as greater experience and expertise and a more flexible asset structure. Finally, the section providing for relaxation of existing usury laws in many states means lending rates can be more consistent with existing market rates. This relaxation should reduce artificial barriers to funds allocation and should enhance the ability of banks to hold interest margins stable over the business cycle.

Changes in funds management as HR 4986 becomes effective should be significant; however, the law has several important deficiencies which may or may not be resolved by future legislation or regulation. For example, there is no provision for removing the remaining constraints on interstate expansion by banks or bank holding companies. Restrictions now imposed under Glass-Steagall, such as those aimed at commingled investment accounts, were not addressed. The continuing competitive advantages of money market funds were largely ignored. The longer-run implications of the fact that low yielding, fixed-rate mortgages will remain a significant part of the portfolios of most thrift institutions and many banks for some years to come was not explicitly considered. These and similar problems cannot be ignored. In my opinion, the problem is that banking legislation and regulation tend to be following, not leading, influences on bank funds management. Legislation and regulation tend to validate or legitimize successful innovations in the banking and depository industry.

Looking at current trends, some legislative or regulatory developments seem likely for the near future. One is some form of relaxation of state boundary constraints in providing some financial services. These constraints are already partly overcome by Edge Act offices, loan production offices, and bank holding company subsidiaries, but using such loophole opportunities is not particularly efficient. Improved electronic technology and the need for domestic rather than international takeovers of "weakened" depository institutions should provide added incentives for some kind of legislative or regulatory action. My prediction is that, before the mid-1980's, we will see at least regional, and probably nationwide, banking permitted.

I am less optimistic about other legislative relief because HR 4986 was passed in the crisis environment of March 1980. The probability of more significant bank legislation in the near-term seems low. Banks must instead learn to live in the regulatory environment of HR 4986. Key areas in which some type of action may be forced on legislative or regulatory bodies include definitions of nontraditional financial services banks can provide; ground rules for how far money market funds, brokerage firms, and other nondepository firms can go in competing with depository institutions without constraint; payment of interest on reserves; and some form of relief for institutions holding significant amounts of previously-acquired, low-fixed-return mortgages.

Trends in the Banking Industry

Finally, in reviewing the environment for funds management decisions in coming years, we need to review the current status of the banking industry itself. How much flexibility will the industry have to face the challenging external and regulatory environment? Will coming technology help or hurt the industry in future years? Will competitive pressure by intra- or inter-industry?

Table 2 shows that in 1950, as a result of the Depression and World War II, commercial banks held over sixty percent of their total assets in cash and due from banks accounts or in Treasury securities. At the same time funds were acquired primarily through checking accounts. Demand deposits made up over seventy percent of total liabilities and capital in 1950. The low average return of banking assets -- caused by the bank asset mix and low interest rates -- meant that banks paid relatively low returns on time and savings deposits and were often not aggressive in trying to obtain funds from such deposits.

The primary emphasis in bank management during the 1950's and early 1960's was a shift from Treasury securities and cash and due from banks accounts to riskier assets with higher returns. While there was some increased emphasis on time and savings deposits as sources of funds, demand deposits still contributed well over half the total sources of funds for most banks. Furthermore, total deposits and assets of all commercial banks grew at an annual rate of less than five percent from 1950 through 1964. During this period, the combined assets of nonbank financial intermediaries grew at an annual rate of roughly twelve percent. Causes of this low growth in banks vis-a-vis other financial institutions included (1) slow demand deposit growth as corporate treasurers began to utilize efficient cash management techniques; (2) significantly lower average rates paid on time and savings deposits than those paid by many other intermediaries; and (3) generally conservative attitudes toward attracting funds by bank managers.

The prevailing philosophy of bank managers and directors appeared to emphasize the profitable lending of attracted funds, at the cost of additional risk. The excess liquidity and low portfolio credit risk of banks during the immediate postwar period was substantially reduced. Table 2 illustrates that from 1950 to 1964 cash and due from banks accounts and Treasury securities fell from sixty-one to forty percent of bank assets, while loans rose from thirty-one to forty-nine percent.

In the early and mid-1960's, banks responded to their relatively slow growth during the preceding decade by (1) requiring loan customers to keep larger demand deposit balances; (2) paying competitive rates on time and savings accounts within the confines of Regulation Q; and (3) aggressively offering certificates of deposit, savings certificates, and other old and new liability sources. Emphasis in management shifted from asset selection to the acquisition of funds -- liability management. This more aggressive acquisition of funds was part of a shift in bank strategy away from high margins and slow growth and toward lower margins with more rapid growth in the early and mid-1950's. This shift was encouraged by gradual relaxing of Regulation Q, which set the maximum rates banks could pay on time and savings deposits, and by allowing banks to use certificates of deposit and other liability forms to compete more effectively for funds. The strong demand for credit from the mid-1960's through the 1970's allowed banks to employ the substantially larger amounts of funds they were able to attract.

The surge in asset and loan growth was pronounced -- the rate of asset growth doubled to rates averaging nearly ten percent annually from 1962 through 1979. By comparison, in this same period, the assets of nonbank financial intermediaries grew at an average annual rate of slightly less than seven percent.

The change in the composition and financing of this growth was even more remarkable. Demand deposits declined from fifty-five percent of total liabilities and capital in the mid-1960's to slightly under thirty percent of total liabilities and capital by the end of 1979. Time and savings deposits increased from thirty-three percent of total liabilities and capital in the early 1960's to fifty percent by 1979. Borrowing and other liabilities increased from a relatively small source of funds to nearly fourteen percent of total liabilities and capital in this same period. On the asset side, cash and due from banks accounts and Treasury securities declined absolutely as well as relatively, while loans continued their rapid growth (increasing from forty-nine to sixty-one percent of total assets from 1964 through 1979), and other securities (nearly all of which are state and local issues) increased rapidly from ten to thirteen percent of total assets.

These broad trends indicate banks will probably be exposed to greater risk in the early 1980's than they have been at any time since the early Depression years. Options, such as conversion from low-cost, core demand and savings deposits to interest-sensitive deposits and shifts from securities to higher-earning, higher risk loans, have already been partially utilized. Flexibility of bank funds managers is very limited in the challenging economic and regulatory environment predicted (in the preceding section) for the 1980's.

Technological changes in the 1980's complicate efforts to predict how many banks will fare in coming years. The pace of technological change for banks has been slower than many predicted in the last few years. On average, the industry is still dominated by a paper-based brick-and-mortar, customer-bank-employee-interaction delivery system. There are, however, recent developments which indicate substantive movement away from this system is taking place. The technology exists to alter banks' delivery systems rapidly. This technology consists of advances in computer capabilities, which permit easy and inexpensive gathering, storing, analyzing, and retrieving of customer data and of advances in communication hardware and software which permits convenient access to customer records at great distances. In my opinion, we are at the threshold of a veritable revolution in the delivery system which has significant implications for banking and bank funds management.

In less than five years, I believe, the vast majority of bank transactions will be by electronic impulse made away from the bank's physical location. With existing technology, automated clearing housing, direct payroll crediting, direct bill paying, widespread use of debit cards and POS terminals, and disappearance of float appear highly likely. The technology exists and is being implemented by larger firms and their banks. Furthermore, on a trial basis, some individuals can sit at home and pay bills, make deposits, shift among types of deposits, shift form deposits to other financial assets, etc., all by electronic impulse.

While in the long run I believe this technology will increase productivity and reduce costs in banking, the transition period will be difficult. This difficulty is compounded by the trying economic and regulatory environment predicted for coming years. Some banks will be willing and able to take the high costs and risk involved while others may still try to drag their feet. The foot-draggers may find themselves rapidly becoming noncompetitive.

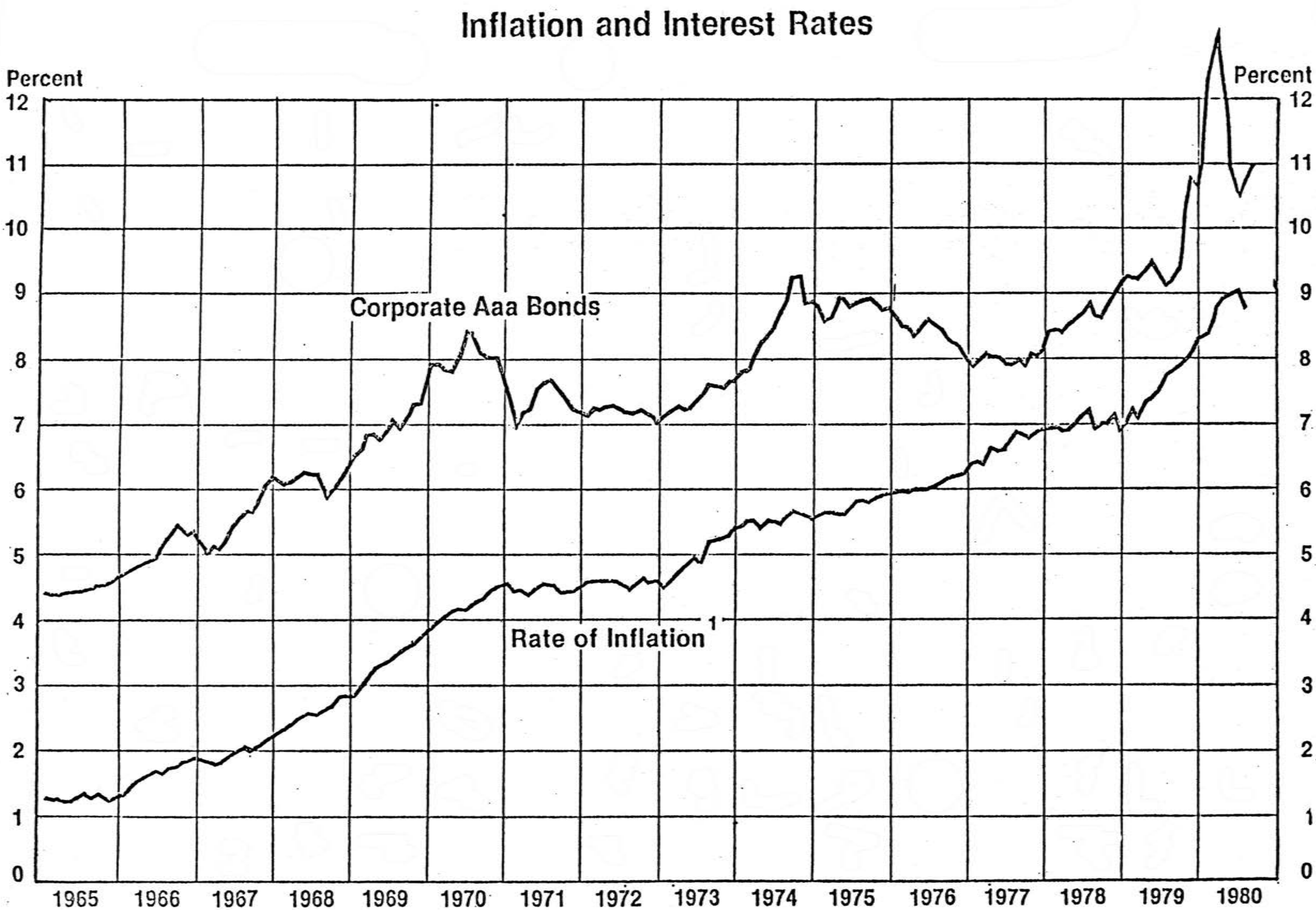
The preceding statement leads to my final area of discussion concerning the status of banking -- the competitive environment. I disagree with the contention that banks' main competition will come from other banks. This contention seems to be based on the idea that other depository institutions will be unable to compete because of their inferior asset position and lack of experience in many banking areas and that banks will somehow be protected from competition of nondepository organizations.

I believe nearly exactly the opposite will occur. Some large thrifts will be very competitive in both attracting and employing funds. Nondepository organizations will use their substantial competitive edge -- less restrictions, no reserves, no capital requirements, less regulation -- to offer more and more banklike financial services. Some of the nondepository organizations providing banklike services are known. For example, much has been written about money market firms, brokerage firms like Merrill Lynch, and large retail chains such as Sears and Penneys offering competitive financial services. Rapid expansion by such organizations in areas competitive with banks appears likely. Furthermore, additional organizations, such as life insurance companies, some large industrial companies, and private pension funds, are looking carefully at segments of banking services they believe would be profitable for themselves.

Conclusions

Where does the combination of a hostile economic environment, a changing regulatory environment, and some worrisome trends in the banking industry leave the bank funds manager? The environment for bank funds management decisions is clearly going to be a challenging one in coming years. I sincerely believe, however, the well-managed banks can and will be very successful in this challenging period.

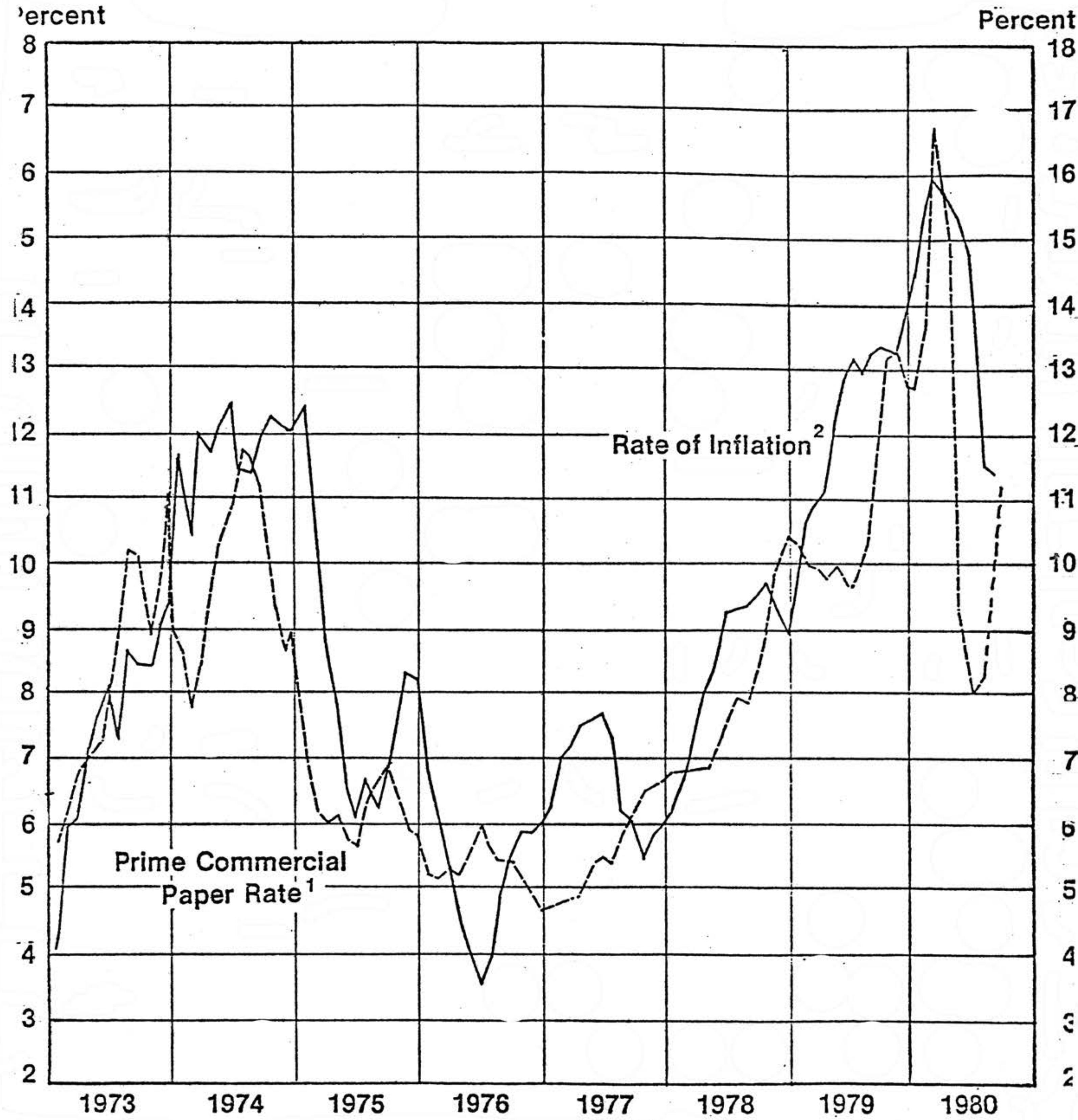
Chart 1



1. Rate of change for Consumer Price Index over five-year periods.
CPI for 1974 was adjusted for estimated effect of the oil price increase.

Chart 2

Inflation and Short-Term Interest Rates



1. Yields on 4 to 6 Month Prime Commercial Paper.
2. Rates of change in Consumer Prices over the previous six months.

Table 1.

IMMEDIATE AND LONGER-RUN EFFECTS OF HR4986 ON BANK FUNDS MANAGEMENT

Actions	Impact Effects	Subsequent Effects
Lower (Higher) Reserve Requirements	Increased (Decreased) Earning Assets and Earnings	-After transition period more equitable competitve environment (less of a differential license fee based on size) -Decreased variation of relative growth rates among varous types of deposits -Reduction in correspondent balances
Federal Reserve Pricing	Increased Explicit Costs Paid to Federal Reserve	-Changes in retail checking services (truncation,pricing) -Changes in "cash management" practices and float -Reduction in correspondent balances -Greater reliance on explicit pricing (fees, service charges) -Stimulus to: debit cards, EFTS, direct deposits, POS, ATM
Introduction of NOW Accounts	Higher Interest Expense of "Core Deposits"	-Higher average "personal checking" balances -Reduced NSF, overdrafts -Higher reserve requirements on ATS balances that are switched to NOW accounts
Phase-Out Regulation Q Ceilings	Gradual Increase in Interest Costs and Pressures on Margins	-Greater discretion in product design of savings instruments -Decreased variation in relative size and growth rates of various types of deposits -Reliance on explicit interest instead of premiums; enhanced value of "one-stop banking"
Higher FDIC Insurance Level	Higher Insurance Fees	-Potential for marketing distinction vis-a-vis Money Market Funds, Sears, American Express, and Merrill Lynch
Expanded Powers for Thrifts	Costly Entry of Thrifts into Several New Markets	-Greater competition for obtaining and profitably using bank funds -Narrowing of spread between attracting and employing funds
Relaxation of Many State Usury Laws	Loan Rates More Consistent with Market	-Enhanced ability to hold interest margin stable over credit cycles -Reduced artifical barrier on fund allocation

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