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DARWINISM AND THE ECONOMIC EVOLUTION

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DARWINISM AND THE FINANCIAL SERVICES EVOLUTION

California is truly a laboratory filled with plentiful evidence of the rapid evolution of financial institutions of all types. The evidence is not fossilized remains embedded in the strata of previous stages of evolution: rather it comprises a 60-year record of financial innovation.

Since the 1920s, California has led the way in branching systems for institutions, a cornucopia of consumer services, successful retail banking, and innovations in mortgage lending and mortgage-backed securities. Continuing innovations in providing community-backed financial services is evidenced by the plethora of successful de novo commercial banks and thrift institutions in the face of intense competition by existing institution management.

Far from being a fossil from a bygone era, the community bank may be emerging as a principal competitor in the financial services industry. If community bankers choose the right niche, and a correct combination of strategic and tactical alternatives, community banking will continue to evolve into one of the stars in the firmament of banking. Darwinism will prevail: the race is won by adaptation.

The structure of commercial banking is no longer a subject for the technician or the specialist. The United States has become a service economy, one in which most of us are employed in the production and consumption of services, not of goods whether manufactured or harvested. Of course, in part, this is a function of the plethora of governmental services which the "public" demands through its elected representatives. The consumption of financial services has increased markedly over the past decade. We have a sharpened awareness of the costs of borrowing and the opportunities of income from savings and from financial investments.

Inexorable market forces have compelled financial institutions management to change and adapt. For some, a major objective is to become a "financial supermarket." This objective is understandable as commercial bankers have witnessed the loss of market share to thrift institutions and money market fund managers in deposit markets. Deregulation of deposit instruments has enabled a recapture of some of the share loss to the money market funds but at rising costs for funds. The blurring of the lines between and among different kinds of financial institutions leads management to strategies of providing financial services as well as traditional banking to its increasingly sophisticated customers. The most obvious example is the discount brokerage now being offered in one form or another by many of the large commercial banks and thrift institutions.

Perhaps a reference to a Darwinian matter may be helpful. Europe was inhabited only by humans of the Neanderthal type 35,000 years ago. Dr. Robin Torrance has been cited by the <u>London Economist</u> as pointing toward those factors which caused Neanderthal man to be replaced by modern-looking man. Sheffield argues that the Neanderthals did not adapt to very fundamental environmental changes and that modern man prevailed through the means of technology, particularly weaponry. Is the computer and communications equipment the equivalent of the throwing spear and the bow and arrow in today's survival of the fittest? I think the analogy is a bit strained here.

This is not to deny that one-stop shopping for financial services does not have its advantages, but there are disadvantages. Indeed, it is not completely clear that the small institution cannot through franchising, leasing lobby floor space, and other joint participation techniques provide a multiplicity of financial services. Furthermore, financial services supermarkets will offer different products of varying convenience and quality. It is a rare management which is equally competent in several fields. One commercial bank may offer a single insurance carrier, another may offer several. One bank management may sell only the mutual funds with which it is affiliated, another may specialize in no-load or tax-advantaged types. Already some commercial banks are affiliated with full service brokers with expensive research departments while others are related to discount brokers with a purely order-taking function. As the evolutionary process stimulates adaptation, the odds are that each commercial bank or thrift will offer some services in a really competitive way and other services which can be obtained elsewhere advantageously. The conclusion is that the financial services supermarkets of the future will not eliminate the community bank from all submarkets or even from most.

It is instructive to review the current situation from which tomorrow's community bank will evolve. Let us examine the record in terms of the following characteristics:

- o profit performance,
- o growth,
- o economies of scale,
- o technology, and
- o risk.

PROFIT PERFORMANCE

Today's community banks, those under $100 million assets, generally have a higher return on assets (ROA) than larger banks. They also appear to have a lower risk position measured by capital ratios and liability structures. First half 1983 profit statistics indicate that the banking system as a whole had an ROA of 0.75% while community banks had an

ROA of 1.18%. Large money center banks had an ROA of only 0.54%. What happens to the profit of a community bank when a subsidiary of a large bank holding company enters its submarket? There is evidence that in many markets the profitability of community banks is not significantly affected. At the "bottom line" community banks have demonstrated a credible track record at this stage of their evolution.

GROWTH

A number of current studies substantiate that the rate of growth of community banks has generally exceeded that of large banks; especially banks with assets over $1 billion. A more important observation is that generally the growth rates of community banks do not appear to be affected by the entry of larger competitors into their submarkets whether through acquisition or on a *de novo* basis.

Submarket entry by larger banks, of course, leads to increased competitive pressures. However, it may be that a resulting shift in management practices of community banks is generated by enhanced competition. More importantly, community bank managements often are stimulated to increase their market share as a result of this competitive process. The message appears to be that management of some smaller banks can respond to competitive challenges posed by new large market entrants.

ECONOMIES OF SCALE

The jury is still out on the question of whether economies of scale are generally important to the overall banking industry. In retail banking with multiple branches, costs have mitigated against such economies. However, some studies have shown that average operating costs (as a percentage of assets) appear to decline in banks with deposits of up to $75 million. Thrifts appear to experience the same phenomena until deposits reach $500 million. Bank holding company affiliation appears to have an insignificant affect on overall operating costs. As retail (branch) business is succeeded by ATM networks or by banks stressing a "wholesale" banking format, the subject will require new studies. At this stage, however, the case has not yet been made conclusively that bigger is necessarily better in all submarkets. Obviously there are national markets and international markets not open to the smaller community-based institution.

TECHNOLOGY

Today we stand on the threshold of a world-wide payment system network of almost infinite complexity, one whose settlement processes can be in microseconds and whose observation is or soon will be on a real time basis. Large dollar payment networks such as Fedwire, the New York

Clearinghouse CHIPS system, international flows by SWIFT, handle balances measured in the trillions of dollars not just the billions. Certainly it is true that the community banker is paying more for his funding these days, 150 to 200 basis points, and he is faced with competition for loans which tends to hold down his margins. Add to that the necessity of capital investment to keep up with technological change and his survival appears threatened. Fortunately, the capital investment is becoming easier as hardware and software costs decrease. Also, many services that cannot be produced economically by community bankers can be distributed by outside vendors through their auspices. Travelers checks and credit cards are good examples. While there are only a few brands of travelers checks, there has been entry into the business and it has become highly competitive. The inability to offer its own brand of travelers checks has not seriously handicapped the community bank. The parallel argument is made for bank credit cards. Today we see the beginnings of shared automated teller machine networks that are city-wide, region-wide, and cross state lines.

Of course new technological developments will require sophisticated data processing systems, but a whole industry of outside vendors will be competing to provide these services to bankers.

RISK

Are community banks judged more risky than large banks? In my view, no systematic evidence appears to exist that small banks (i.e., community banks) are placed at a competitive disadvantage in terms of risk. Risk in community-based banks being defined in terms of:

- o credit risk
- o interest rate risk
- o operating risk
- o managerial risk

Of course, credit risks can be generated by credit originations being geographically concentrated and interest rate risk may be present due to past operating strategies. However, in my view, bank size and risk does not appear to me to be directly correlated with competitive disadvantage.

What is the future of community-based banking? Should or will community-based banking in the 1980s and 1990s be business as usual? I think not. The increasingly competitive banking environment will not easily allow any bank to pursue a status quo situation: even if past profit performance presents a rather rosy picture.

You recognize that the banking environment is changing into an industry that is more fine-tuned to serve the needs of commercial and retail consumers. The continuing deregulation of the financial services industry mandated by the Depository Institutions Deregulation and Monetary Control Act of 1980, in my view, will facilitate increased competition and specialization; a fertile environment for community banking.

California's financial institutions combine financial innovation with the entry of new, smaller competitors. In 1982 California's new *de novo* independent banks accounted for over 10 percent of such banks in the United States.

A study of *de novo* California independent banks opened in 1970-1977 indicated that over 80 percent of such banks were still independent at the end of 1982. Additionally, the return on equity (ROE) achieved by these banks was not significantly different than the population of all California independent banks. In my view, these are convincing statistics to support the continuing viability of community-based banking and the innovation of California bankers during one of the most challenging periods in the history of the financial services industry.

INTERSTATE BANKING

Finally, we have the key restructuring issue: What changes in the banking industry would result from allowing full interstate banking? The means by which some interstate operations are now conducted have been cited many times. We know there are loan production offices, offices of nonbank subsidiaries of bank holding companies and Edge Act corporations. New England has pioneered a regional interstate banking concept. Once again, advocates of full interstate banking have had their hopes aroused as Alaska, Maine, and New York have made provisions for the entry of out-of-state bank holding companies. Given that no state provided for out-of-state entry from 1956 until Maine changed its law in 1975, the recent flurry of activity in this area is significant. The number of actual acquisitions that result from these legislative changes remains to be seen. Litigation involving interstate "nonbank" operations is ongoing.

Would the general introduction of interstate banking produce a major restructuring of the banking system? The answer appears to be that interstate banking could, but doesn't have to be, the catalyst for restructuring. I would like to spend a few minutes examining the evidence on this point.

First, and most importantly, the introduction of interstate banking does not mean that community banks are doomed, although some will of course sell to out-of-state banks. The research done by our staff does not suggest that there are any basic economic forces requiring massive consolidation. As I indicated earlier, the economies of scale argument is not substantiated by the evidence.

Just as small banks can survive and compete profitably in an environment of statewide bank holding companies, I believe that a well-managed community bank can prosper with interstate banking. Those banks that have been protected from new entry into their markets will have to sharpen their skills, control their expenses, and select those sectors of the financial marketplace they can serve most efficiently and profitably. The strongest factors they have going for them are their knowledge of their market, their customers, and their customers' banking needs. They must provide those services at competitive prices so as to maintain customer loyalty in the face of new entry into the market.

A major concern in interstate banking involves the large bank's attention to community credit needs. Will the local branch of an out-of-state bank be responsive to the credit needs of the community? Some fear that the small town branch of the large out-of-town bank will simply siphon off deposits to its home office. The bank that does not meet local credit needs is clearly not going to be very profitable in the long run. People expect that the bank that holds their deposits is also going to meet their credit needs. If there are unmet local credit needs, other banks will be attracted into the market. Thus, the failure to lend is a policy destined to produce losses. While there are other factors to be considered in the debate over the merits of interstate banking, I think we have covered sufficient ground to suggest that interstate banking per se should not be an inevitable cause of a radical restructuring of the financial system.

For us in our roles as consumers, the evolution of the financial services industry is very positive indeed. Of course we will become accustomed to shopping for financial services in new ways. Whether we patronize a "Megabank" or our community banker, we will have the opportunity of the convenient purchase of several services in one location and the confusing excitement of access to as much technology as we want to subject ourselves.

The march of evolution for the management of financial institutions will be likewise as uncomfortable and as exhilarating. For some, the changing environment will simply not be worth adapting. To others, the satisfaction of competing with a larger institution will make managing fun again. My argument here is that neither the economics nor the regulatory environment of the future precludes a mixture of sizes and types of financial specialists and generalists, some local, some interstate, and some international. Darwin would be proud.