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Remarks by
Alan Greenspan
Board of Governors of the Federal Reserve System
before the
Annual Convention
of the
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This is the fifth time I have addressed the IBAA annual convention. Over those years, both the problems facing community banks and the environment in which they operate have changed quite a bit. Today, I would like to discuss some of the broader challenges facing America's community bankers, and how one of those challenges—technology—affects the economy more generally.

If we had surveyed the members of this association over the last few years about their most significant concerns, the list at one time or another would certainly have included loan quality, interest rate risk, the increasing layering of regulations, and supervisory rigidity. Some of these are no longer issues, others have been greatly reduced in importance, and a few have been incorporated into day-to-day operations so as to be only a dull pain.

But I would venture the guess that the three concerns that community bankers have continued to discuss among themselves as the fundamental challenges to their survival are interstate banking, ongoing industry consolidation, and relentless technological change. Many pundits have concluded that these forces will destroy small banks by making them quaint symbols of the past.

I think these prognosticators are plain wrong. The evidence seems clear that, despite these powerful forces, well-managed community banks will not only survive, but will continue to be among the more innovative in our nation's financial system. Community banks will maintain their significant contribution to economic growth by providing specialized and flexible financial services to small businesses, households, and others. But I must quickly add that ignoring the fundamental changes going on in financial delivery systems—and not adapting to them—could well contribute to the demise of the individual bank so inclined. Such unresponsive

banks—and some still exist, at least for the time being—are not, by definition, showing the creativity that has characterized community banking, and there is no reason policymakers should be concerned about their individual competitive demise

The Riegle–Neal Interstate Banking and Branching Act of 1994 already allows nationwide interstate banking through bank holding companies and will allow interstate branching next year. This Act will accelerate, but not fundamentally change, what has been a fact of life for several years: interstate *banking*. Indeed, about one-fourth of domestic deposits are already held by out-of-state banking organizations. I do not mean to understate the importance of interstate *branching* when I say the more significant contribution of Riegle–Neal is permitting interstate operations everywhere on the same basis—except for branching in states opting out of interstate branching, so far only Texas. Prior to the 1994 federal legislation, the lack of uniformity in interstate banking laws had hindered the equitable erosion of the anticompetitive state laws designed to protect local banks from out-of-market competition. But whether by prior state modification or as the result of federal legislation, those banks whose profitability, and hence survival, had before depended solely on protection from geographical competition will not survive in the new environment.

As you know, entry from out-of-market, let alone out-of-state, has been almost entirely by acquisition of existing local rivals rather than the creation of *de novo* banks or branches. With the number of rivals in local markets unchanged, out-of-market acquirers generally have not been able to increase the market share of their acquired institutions. Apparently, knowledge of local markets and old-fashioned banking skills have been more than a match for the new entrants. I might note that the long-held fear that out-of-state rivals will cut prices on services to build market share is not supported by the evidence we have regarding fees. Federal Reserve sponsored

surveys of bank fees indicate that, on average, the highest fees in local markets are levied by out-of-state banking organizations who, in turn, are not charging significantly lower fees than they charge in their home markets

Let me be clear I am not saying that the impact of a substitute rival leaves competitive pressures in local markets totally unchanged Although some bankers have indicated that it is easier to compete against a large out-of-market firm than the same size local firm that knows the market, I believe that generally local banks have found it necessary to respond to the new, perhaps more aggressive, entrant that purchased an already existing competitor Nonetheless, it seems clear that well-managed community banks have done well in such markets by drawing on their expertise and knowledge and managing their costs, and I see no reason why this will change To be sure, branch banks and multi-bank holding companies can offer some services that local banks cannot, such as services over a wider area Even here I would note, however, that ten states already permit independent state banks to form agency relationships with other banks for deposit gathering, loan collection, and other services in order to match many of the things branch systems can offer Twenty-one states permit such agency relationships among state banks in the same holding company I expect other states to follow soon And while, to date, not many banks have opted to use these powers, there is reason to expect them to do so as part of the continuing innovative response and leadership that is the hallmark of the dual banking system

Most interstate banking has been accomplished, as I noted, by acquisition rather than by establishing *de novo* offices Acquisitions by out-of-market organizations result in a consolidation of the total number of banks in the country, but no change in the number of local market rivals Much of the recent merger activity,

however, has been in-market consolidation, resulting in both a reduction of the total number of banks *and* in the number of rivals in local markets. Community bankers have been active participants in this form of merger activity. For both large and small banks, these in-market acquisitions, like interstate mergers, are intended to create efficiencies of scale and scope by eliminating redundancies and duplications, and by leveraging the different skills from the component banks. Often the stated reasons for such mergers include phrases like “better control of the market,” which is, let us admit, a not very cryptic code for reducing competitive pressure, often in pricing.

Like the Justice Department, the Federal Reserve and the other banking agencies, however, are required by law to ensure that mergers do not significantly reduce competition in local markets. Indeed, the mergers that are substantially inconsistent with Justice Department and agency guidelines never even result in formal applications. In addition, approval of an in-market merger is often conditional on the divestiture of offices in local markets in which the surviving bank would otherwise become excessively dominant. In part for these reasons, even with the well-publicized wave of very large consolidations, local market concentration ratios have risen only marginally. It is in these local markets where the competitive battle is fought among community banks and the regional and giant banks.

Application of the banking and antitrust laws may have mitigated the competitive impact of in-market mergers on the other banks in the local market. But more important, in my judgment, has been the economics of the marketplace that limit the competitive strengths of merged banks. The best evidence we have is that economies of scale—that is, the efficiencies that are alleged to come with greater size—are quite limited. Indeed, in explaining performance, differences in management effectiveness among banks of *similar* size dominate any efficiencies (or inefficiencies)

that are connected directly to size per se. *Within* each group—community banks, regionals, and giants—the cost differences associated with management skills are much more dramatic than the cost differences *between* size groups. And, for reasons we do not fully understand, efficient banks that acquire inefficient banks do not seem to be able consistently to transfer their efficiencies to the consolidated unit. This result, it seems to me, cannot hold much longer. As you know better than I, the ongoing powerful competitive pressures will make survival of the inefficient banks in all size categories unlikely.

In contrast to the record of earlier years, some of the recent consolidations have brought not only cost-savings, but apparently efficiencies as well. In the new competitive environment, all acquirers are cutting costs, but it is important to underline that cost cutting does not result in efficiency gains, which require that revenues fall by less than costs (or rise by more than costs). Be that as it may, it appears that resultant cost savings and any associated increased efficiencies are less the mechanical/technical dividends of scale, and more the result of actions that could have been taken separately by the component banks. Interestingly, many of these efforts, such as reducing management overhead or eliminating unprofitable lines, may have not been feasible without the substantial rearrangement implicit in a consolidation. Whatever the reason, consolidation in some cases—not all—seems to have resulted in efficiencies. More and more, I believe, the surviving banks—large and small—will have to be efficient in all the dimensions of that term, and will be under constant pressure to remain so.

For these reasons, most forecasts of the future United States banking structure project a substantial reduction in the number of American banks. But these same projections also predict that thousands of banks will survive the consolidation.

trend, reflecting both their individual efficiencies and competitive skills, on the one hand, and the preferences of the marketplace on the other. Such analysis, done by the Federal Reserve Board's staff and others, merely reinforces my own view that the franchise value of the U S community bank—based on its intimate and personalized knowledge of local markets and customers, its organizational flexibility, and, most of all, its management skills—will remain high, assuring that community banks continue to play a significant role in the U S financial system.

Other observers are not so sanguine, arguing that changing technology may be the real slayer of banks, especially community banks. This argument has at least two strands. One is that technology reduces the degree of financial intermediation needed by society because it permits economic units to directly create their own financial contracts as both asset and liability holders. Banks, it is argued, will be replaced by virtual banks, and the future J P Morgan will not ask for your person to see my person, but will ask your computer to see my computer. The other strand of the argument is that it takes substantial resources and skills to develop and use the new technology, and that because small banks do not have such resources they will not be able to maintain their position.

Let's look at the second argument first. This very convention—whose theme is "Tech World"—belies this thesis. I know that a critical reason for you attending this convention is to hear the scintillating speeches, such as mine, but the displays of equipment and software are not irrelevant. Not only is the technology for sale, often by larger banks, but the services that come from that technology are also for sale. The community bank of today is as different from a small bank of 20 years ago as is the giant bank from its predecessor. Both have fundamentally changed the way they do business, provide the customer service, and manage risk by using computer.

technology. For example, smaller banks are among the end-users of derivatives to hedge risk, even as the larger banks are the dealers in such instruments. Both are using the fruits of the new technology.

There is no question that technology is among the critical causes of the financial revolution that has swept the world in the last two decades. It has changed the way banks do business and has increased the number and kinds of bank competitors. But to conclude that banks—especially community banks—will not continue to be significant participants in the financial system does not square with the facts. Community banks have always focussed on local face-to-face customer contacts. Yet as technology has deepened, we find that most large banks are increasing, not decreasing, their branch systems as they relearn what community banks have always known. Meeting customer demands on the customers' terms remains the name of the game and the customer continues to demonstrate his desire to deal with an institution that is conveniently located. Moreover, community banks have already showed their skill in using technology to meet customer preferences. I fail to see why community banks will not continue to do so. Small does not mean unadaptable, and it certainly does not mean inefficient.

In sum, as you think about interstate banking, consolidation, and changing technology, I urge you to continue to worry, because concerned management means efficient management. But don't worry too much because your efficiencies suggest that you will more than hold your own against intra- and interstate competition and consolidation, virtually regardless of technological change.

The same relentless pressures of technological change that has revolutionized banking and the financial system has also been at work in the economy.

at large. The pressures to improve productivity and contain costs range far beyond the financial system. And they seem to have been effective.

Increases in producers' costs and in output prices, for example, proved to be a little lower last year than many had anticipated. While it is too soon to draw any definitive conclusions, this experience provides some tentative evidence that basic, ongoing changes in the structure of the economy may be helping to hold down business costs and price pressures. Successive generations of new technologies are being quickly embodied in the nation's capital stock and older technologies are, at a somewhat slower pace, being phased out. As a consequence, the nation's capital stock is turning over at an increasingly rapid pace, not primarily because of physical deterioration, but reflecting technological and economic obsolescence.

The more rapid pace of technological change is reducing business costs through a variety of channels. One important channel, the downsizing of products resulting from semiconductor technologies, together with the increasing proportion of national output accounted for by high-tech products, has reduced costs of transporting the average unit of GDP. Quite simply, small products can be moved more quickly and at lower cost.

More recently, dramatic advances in telecommunications technologies have lowered the costs of production for a variety of products by slashing further the information component of those costs. Increasingly, the physical distance between communications endpoints is becoming less relevant in determining the difficulty and cost of transporting information. Once fiber-optic and satellite technologies are in place, the added resource cost of another 200 or 2,000 miles is often quite trivial. As a consequence, the movement of inputs and outputs across geographic distance is

progressively becoming a smaller component of overall business expenses, particularly as intellectual—and therefore immaterial—products become proportionately more important in the economy. This enables an average business firm to broaden markets and sales far beyond its original domicile. Accordingly, fixed costs are spread more widely. For the world market as a whole, the specialization of labor is enhanced to the benefit of standards of living of all market participants.

One would think that the evident step-up in technological advance would have been matched by a pickup in the growth of productivity nationwide. It certainly has been the case in banking. However, to paraphrase Nobel Laureate Robert Solow, we see technological advance everywhere but in the productivity statistics. To a degree, the lack of any marked improvement in the national data on productivity growth may be a shortcoming of the statistics. Faulty data could be arising in part because business purchases are increasingly concentrated in items that are expensed but which market prices suggest should be capitalized. Growing disparities between book capital and its valuation in equity markets may in part reflect widening effects of this misclassification. If this problem is indeed growing, we may be underestimating the growth of our GDP and productivity.

This classification problem compounds other difficulties with measuring output in the increasingly important service sector. The output of services—and the productivity of labor in that sector—is particularly hard to measure. In part, the statisticians have simply thrown up their hands, gauging output in some service industries just in terms of labor input. Should medical output, for example, be measured by the number of physicians, nurses, and other medical personnel at work, or by the dramatic advances in medical outcomes? In manufacturing, where output is

more tangible and therefore easier to assess, measured productivity has been rising briskly, suggesting that technological advances are indeed having some effect

Nonetheless, there is still a nagging inconsistency. The evidence of significant improvements in technology and reductions of real costs within business establishments does not seem to be fully reflected in our national productivity measurements. It is possible that some of the frenetic pace of business restructuring is mere wheel spinning—changing production inputs without increasing output—rather than real increases in productivity. One cause of the wheel spinning, if that is what it is, may be that it takes some time for firms to adapt in such a way that major new technology is translated into increased output.

In an intriguing parallel, electric motors in the late nineteenth century were well-known as a technology, but were initially integrated into production systems that were designed for steam-driven power plants. It wasn't until the gradual conversion of previously vertical factories into horizontal facilities, mainly in the 1920s, that firms were able to take full advantage of the synergies implicit in the electric dynamo, thus achieving dramatic productivity increases. Analogously, existing production systems today to some degree cannot be integrated easily with new information and communication technologies. Some existing equipment is not capable of control by computer, for example. Thus, it may be that the full advantage of even the current generation of information and communication equipment will be exploited over a span of quite a few years and only after a considerably updated stock of physical capital has been put in place.

Our nation faces many important and difficult challenges in economic policy. Nonetheless, we have made significant and fundamental gains in

macroeconomic performance in recent years that enhance the prospects for maximum sustainable economic growth. And, as technological advances are absorbed more and more into the way firms do business, the years ahead should see improved productivity growth, further progress against inflation, and a macroeconomic climate in which the nation, the financial system, and the banking community can address its other economic challenges.

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