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Remarks by

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Chairman

Board of Governors of the Federal Reserve System

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It is a pleasure once again to participate in the annual meeting of the Independent Community Bankers Association. I particularly hoped to attend this meeting in person, but events made such a trip infeasible.

I wanted to be at your meeting to join in honoring the contributions of Ken Guenther. As everyone knows who has ever received Ken's notes--known fondly to one and all as "Guenther-grams"--he thinks deeply and broadly about banking and financial matters.

Having reflected on the kinds of issues that Ken has on his mind, I thought it would be fitting today if I shared with you some ideas about where the banking industry is today and about a few trends we see evolving.

**Asset Growth and Quality**

The weakness in credit quality that accompanied the recent recession has clearly been mild for the banking system as a whole, and the system remains strong and well positioned to meet customer needs for credit and other financial services. During the past three years or so, the industry extended its string of high and often record quarterly earnings, retained its historically high equity and risk-based capital ratios, and generally enjoyed robust asset growth. The industry and its supervisors had begun exceptionally early to address slippage in credit standards that accompanied the maturing of the last expansion, and their timely intervention was reflected in modest subsequent write-offs relative to earnings. Indeed, for each of the past several quarters the volume of problem assets at commercial banks has declined, and the size and the number of bank failures in recent years have been exceptionally small.

Although the demand for business loans has remained weak, the banking industry has continued to benefit from strong demand for household credit, not least for residential mortgage products. The outlook for asset quality is also favorable. As economic activity continues to grow and businesses become more confident about their customers' demands, business loan demand should increase, and pressures on banking margins should begin to ease.

During the period of weakness and recovery, quite a large amount of core deposits flowed back into banks of all sizes reflecting lower interest rates on alternative assets, the softness of the stock market, and the public's desire for safe assets. As a result, banks had ample liquidity and the resources to fund asset growth. More recently, with renewed interest in market securities and a slowing of mortgage re-financings--and their associated buildup in deposits--core deposits have weakened. History suggests that, as the economy strengthens further, deposit substitutes again will become more attractive to bank customers, requiring competitive responses in bank deposit offering rates and reliance on non-core sources. Community bankers in the last half of the nineties demonstrated their skill in competing successfully in such markets.

Although their deposit patterns have been similar, community and larger banks have seen some interesting differences developing in their portfolios in the past two or three years that are worth noting. Banking commentary generally has emphasized the extent to which residential mortgage finance and consumer credit extensions have dominated the portfolio expansion of the banking industry. In fact, that growth, which dominates the aggregate statistics, has been mainly a large bank phenomenon.

At community banks, the residential mortgage, credit card, and consumer installment loan portfolios have *declined* in each of the last three years. To be sure, this change may be a matter of choice. The data suggest, for example, that community banks have originated a significant volume of mortgage loans for securitization by others, continuing to acquire in the process a large amount of mortgage-backed securities. But some observers have noted that in the market for new originations of mortgages community banks are also under continued competitive pressure from mortgage bankers, nationwide mortgage lenders, and real estate agent relationships with out-of-market lenders, often through the Internet.

The declining importance of traditional consumer credit business at community banks appears to stem from both sustained competition from captive finance companies and community banks' withdrawal from the credit card market, where significant scale is required to service the resultant portfolios. Community bankers, however, continue to have success with home equity loans as a substitute for more traditional consumer lending and have experienced growth in such loans comparable to that at larger institutions.

Particularly noteworthy is the longer-term trend at community banks that seems to have accelerated in the past three years--the increasing share of asset growth accounted for by nonresidential real estate finance, particularly construction and land development loans and commercial and industrial real estate financing. Last year these categories accounted for more than 90 percent of the net asset growth of banks with less than $1 billion in assets; multifamily real estate and farmland finance would bring the total to more than 100 percent, offsetting the declines in other categories.

Such credit exposures are a natural evolution of community banking and are quite profitable, helping to sustain both the earnings and growing equity capital of community banks. Moreover, the evidence suggests that community banks have avoided the underwriting mistakes that led to so many problems ten to fifteen years ago. Borrower equity is much higher and credit criteria are much stricter. In the last recession and during the early weak recovery, we saw very few delinquencies in these credits. Nonetheless, bankers need to be aware of the historical real estate cycle that, in the past, placed such exposures under severe stress. One hopes these improvements in underwriting standards are lasting. But the painful lessons of banking history underscore the ever-present need for vigilance in managing geographic and business line concentrations.

**Consolidation**

Mergers and acquisitions in banking continue, driven by technology, reduced barriers to entry, relaxation of interstate banking restrictions, and globalization. Although attention has been focused on the larger banks, roughly 90 percent of mergers over the past decade have involved a target with less than $1 billion; three-quarters have involved an acquiree with assets of less than $250 million. Largely as a consequence, the number of banking organizations with assets of less than $1 billion has fallen since the mid-1990s by more than one-fifth.

Neither the aggregate decline in the number of banking organizations of all sizes nor the increase in aggregate concentration ratios tells us much about the competitive effects of consolidation. Competition in banking is fought on the battlefield of the local market, especially for households and small and medium-sized businesses. By that test, concentration in local markets has actually declined somewhat since the mid-1990s in both urban and rural local markets. The apparent contradiction between aggregate consolidation and the virtually unchanged local market structure reflects the fact that many of the mergers and acquisitions by all sizes of banks have been out-of-market, or geographic-expansion, mergers. In addition, when consolidation occurs, it often induces de novo entry to take advantage of the inefficiencies or transition difficulties of the newly consolidated enterprise. Over the past five years, for every four bank mergers that have been approved, three de novo bank charters have been granted.

To be sure, expansion by large banks through acquisitions and branching has increased the number of local markets--urban and rural--in which a large institution is a rival. Last year, 99 percent of the urban markets and 54 percent of the rural markets had an office of a banking organization with deposits of $25 billion or more. Such an increase in the presence of large banking organizations at the local level has occurred while community banks continue to face competition from thrifts, credit unions, securities firms, and loan production offices from out-of-market lenders, not to mention the Internet. These trends are irreversible. Nonetheless, as evidenced by their performance, community banks have the competitive skill of innovation and the competitive edge of local market knowledge not just to survive against such competition but to continue to prosper.

**Basel II**

Every indication to date also suggests that the proposed application of Basel II in the United States to only large banks should not be a matter of concern to community bankers. Indeed, your comments on our proposal to revise the Basel Accord suggest that you are comfortable, to say the least, with not having to invest in the institutional infrastructure to be required of the largest banks. The agencies believe that the generally strong capital position and straightforward balance sheets of most of the other banks make a wider application of Basel II neither cost effective nor necessary on prudential grounds. Of course, supervisors will continue reviewing credit-granting and risk-management policies at banks of all sizes, and I suspect that, in the years ahead, market-driven spin-offs from the new procedures at larger banks will be adopted by community banks.

Apparently another fear exists. The comments received from some of you indicated a concern that perhaps the lower *regulatory* capital that some large banks may incur under Basel II on *some* portfolios may distort the competitive balance between adopters and non-adopters of the proposed new accord. The banking agencies and the Congress take such risks seriously. Indeed, we have indicated that if we see evidence supporting competitive distortions, we will make the necessary modifications to blunt them by doing one of the following: changing Basel II rules in the United States, where national discretion is allowed; modifying the proposed U.S. bifurcated application; or changing the capital rules that apply to non-adopters. In short, if we have evidence of a potential competitive problem, we will not be precluded from proposing any measure that we believe is necessary to retain a more level playing field.

Two weeks ago, the Federal Reserve published the first two of four empirical studies on this issue that our staff is conducting. One addresses the concern that regulatory capital reductions at adopters of Basel II might induce more mergers and acquisitions, with the adopters acquiring the non-adopters. That paper finds little empirical evidence that, in the past, excess regulatory capital at the acquirer had been a significant factor in boosting consolidation.

The second paper evaluates the fear that the lower on average, risk-based capital charges on loans to small- and medium-sized enterprises by Basel II adopters would put non-adopters at a competitive disadvantage. This study concludes that the empirical evidence suggests that, indeed, a competitive issue in this market might arise between adopters and *large bank* non-adopters, both of which make the same types of loans in the same markets. This potential effect must be addressed. But the study also concludes that, on the basis of empirical review, the types of small business loans generally made by community banks--relationship-based loans, which community banks do so well--are so different from the types of loans made by larger banks, and so differently priced, that the competitive effects on community banks of Basel II application to large banks are likely to be insignificant.

Two other studies, exploring the competitive effects in the residential mortgage and credit card markets will be available in the next few months. The results of all four studies will be reviewed when we conduct later this year another Quantitative Impact Study on the revised Basel II now being developed. And, again, if updates of the completed studies or the analyses in the new studies demonstrate competitive problems, we will modify the proposals to address them.

**Summary**

In summary, the banking system is in a strong and profitable position to finance the credit demands of the current expansion. As that expansion continues, both large and community banks will have to once again look beyond their core deposit base to fund those demands. The competitive environment for banks, especially community banks, will continue to intensify. Both history and current behavior suggest, however, that community banks can innovate and meet these competitive challenges. The merger trends of both large and small banks will undoubtedly continue, but both public policy and new entry will also continue to limit concentration in local markets. If evidence shows that a bifurcated application of Basel II would distort competitive markets in the United States, the agencies are pledged to make whatever modifications are necessary to either the proposal or the current capital rules. And, finally, once again: Ken, I wish you a productive and enjoyable retirement.