For Release on Delivery
(8:30 a.m. PST)
March 20, 1985

FINANCIAL SERVICES EVOLUTION

Remarks by Preston Martin

Vice Chairman

Board of Governors of the Federal Reserve System

to the

Western Independent Bankers

San Francisco, California

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To be a community banker today is to have the opportunity to contribute to widening and deepening the financial services available for your present and future customers. The challenge is to choose among many sets of services which you can "retail," to those customers and among other sets which you can both "manufacture" and distribute or retail. Consumer research indicates that your customer base includes a large and growing segment which is interested in obtaining banking and banking-related services from you. This is not to say that you can realistically aspire to be "all things to all people," or even all things to some people, but that yours is the entry point for obtaining financial services and that you are the trusted source for at least some of them.

I find the potential in your career to be most exciting. On the one hand, you have the opportunity to play the change agent role, of fostering the customer's participation in electronic access, of which check truncation is the kindergarten stage. You can truly help reasonably sophisticated households and businessmen use the automated teller machines (ATMs), drive-in windows, videotex services, the evolving credit-card-to-smart-card devices, and finally home banking services featuring, perhaps, the touch screen terminal designed to fit into a home video complex.

It is apparent to me that your role and even market share can and will survive the onslaught of the giants because no conglomerate can invent an adequate substitute for relationship banking. Maintain those relationships and you can capitalize upon the evolving technology, the super networking which is beginning to relate, for example, what may be 125,000 ATMs by 1988. Automated clearing houses (ACHs) almost have to be the channels through which your payment system impulses will be transmitted. In effect, your customer of the 1990s will be accustomed to financial services availability in any physical location: home, office, store, shop, club, vehicle; and accompanying your service will be access to multiple databases. We have already become an "information" economy, way past the old fashioned "service" society in the simple sense, and your "retailing" of services will be increasingly tied to these information flows.

Thus it is imperative that your strategic planning be an ongoing, all-management activity: that you determine the niches and the market segments you would serve, and that you periodically review the rapidly changing product mix available, its fit with your customer composition, and the oncoming "manufacturers" from whom you can obtain the semi-finished service. You are going to have to take the initiative in some of the products, for you are closer to the customer than the larger competitor/supplier.

Likewise, since your staff cannot become expert in every one of the spectrum of products, the referral process must be handled carefully so as not to fracture the very customer relationship which is your comparative competitive advantage.

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 services 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.

What does this portend for the community bank? I would say that one-stop shopping for financial services does not have its advantages, but there are disadvantages as well. Indeed, it is completely clear that the small institution can, through franchising, leasing lobby floor space, and other product sharing 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 extensive 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 more advantageously.

It may be instructive to recall the thrust toward "conglomerate" organizations in the 1960s. Oil companies bought retailers; manufacturers of consumer goods acquired technology firms. "Synergism" was the watchword, diversification the strategy, and consultants advised on offsetting cyclical patterns of different businesses. The kindest conclusion for the waves of divestments and closings which resulted is that the conglomerates were too complex for all but a handful of management groups.

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:

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

PROFIT PERFORMANCE

Today's community banks, say those under $100 million in assets, generally have a higher return on assets (ROA) than larger banks. They also may have a lower risk position measured by capital ratios and liability structures. There are exceptions among banks with loan concentrations in farming, mining, and other hard-hit industries. 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 and higher money costs. However, it may be that a resulting shift in management practices of community banks is generated by enhanced competition. In some submarkets the community banker has tightened his organization and carefully broadened his services. 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 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. We are over our love affair with branching. 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 phenomenon until deposits reach $500 million. Bank holding company affiliation appears to have an insignificant affect on overall operating costs. As retail (branch) business is partly 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 most submarkets. Obviously there are national markets and international markets not open to the smaller community-based institution, and international markets provide opportunities to experiment with new services like the futures commission merchant and even corporate security underwriting.

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, and 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, including foreign competition, 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 cannot 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.

Of course, credit risks can be generated by credit originations being geographically concentrated (e,g., in the farming sector, presently under fire) and interest rate risk may be accentuated by a few who are fascinated by, say, the reverse repurchase agreements. 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? Of course not. The increasingly competitive banking environment will not easily allow any bank to pursue a status quo situation or the old spread management, even if past profit performance presents a rather rosy picture.

You recognize that banking is changing into an industry that is more fine-tuned to serve the needs of commercial and retail consumers. Continuing deregulation of the financial services industry may be slowed by loan losses and supervisory mergers, but the die is cast for "broader powers," and this, in my view, will facilitate both increased competition and specialization. This can be a fertile environment for community banking.

INTERSTATE BANKING

Finally, we have a last 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 really major restructuring of the banking system? The answer appears to be that interstate banking could, but doesn't have to be, the catalyst for virtually complete restructuring.

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.

Just as community banks can survive and compete profitably in an environment of statewide bank holding companies, I believe that a well-managed community bank can prosper in the face of 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 factor they have going for them is their knowledge of their market, their customers, and their customers' banking needs. Of course, 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 complete 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.

The march of evolution for the management of financial institutions likewise will be as uncomfortable and as exhilarating. For some, the changing environment will simply not be worth adapting to. 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.