Remarks by Governor Mark W. Olson

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Panel discussion: The Competitive Edge of Community Banks

Thank you for inviting me to participate in today's panel entitled: "How Do Banks Compete? Strategy, Regulation, and Technology." This is comprised of participants who have a wide range of perspectives. My comments will focus primarily on the continually evolving competitive environment of community banks. I will begin with an update on the financial performance of community banks through 2003, then I will review the many changes that have occurred in the competitive environment of community banks, and lastly mention a few keys to future success.

Financial Performance in 2003
Community banks--banks with total assets of $1 billion or less--had a record-setting year in 2003, earning profits of nearly $13 billion and a return on equity at 11.55 percent. This outcome is remarkable because of the significant negative factors at work through much or all of the year--a soft equity market, weak demand for commercial loans, and elevated asset quality problems. The origination and holding of mortgage-related assets once again supported industry profits, although the refinance boom ended in the third quarter of the year. Asset quality improved significantly for the industry, providing a boost to earnings through lower provisions. Community banks experienced less of an improvement than the industry did as a whole, but frankly had not seen the increase in problem loans that their larger counterparts did.

All sectors of the industry had a strong year because, very simply, banks large and small built upon their fundamental strengths while adapting to the economic and financial situation. They understood the environment and adjusted their business focus and expectations accordingly. The ability of banks to deliver this level of performance despite the presence of negative factors reflects the effects of changes that have occurred in the regulatory limit that banks face as well as the diminution of some regulatory protections they historically have enjoyed. In addition, banks have performed extraordinarily well, facing numerous fundamental changes in the banking industry's competitive environment.

Evolution of Regulatory and Competitive Environment
Through much of the twentieth century, banking was a very protected market. The McFadden Act of the late 1920s, the Federal Deposit Insurance Act, and the Glass-Steagall Act of 1933, were designed to protect the financial safety net and to support community or neighborhood banks. Strict limits were introduced on all forms of competition, including limits on branching imposed by many states and exclusive access to interest-free deposits and arguably to short-term commercial loans. Banks in turn accepted considerable restriction on their permissible activities. This tradeoff was, on balance, a favorable exchange from the industry's perspective, but also it was perhaps the source of some

frustration to those in the industry because of the limits it placed on banking products and their features.

Market forces gradually changed this arrangement, spurred in particular by high interest rates in the late 1970s and early 1980s. Growth in the commercial paper market eroded the industry's signature product--the short-term commercial loan. The introduction of alternative savings and transaction vehicles--including money market mutual funds--reduced banks' share of household assets.

It is important to note that the erosion of most of these product and market protections did not occur through changes in laws or regulations but through marketplace innovation. The Gramm-Leach-Bliley Act, passed in 1999, is often credited with removing competitive barriers between the banking, securities, and insurance industries. Although that description is true to some extent, many of the barriers had been eliminated through market innovation. In many instances the Gramm-Leach-Bliley Act made federal banking statute more consistent with what had already occurred in the marketplace.

Through all of the changes in the marketplace and in bank regulation, there have nonetheless been a handful of critical competitive factors that provide an "edge" to commercial banks and to community banks in particular.

The first and most obvious competitive factor in the banking industry is deposit insurance. Even with the proliferation of deposit-like products that present relatively low credit risk, there is still something different about a liquid and readily accessible asset of which credit is backed explicitly by the U.S. government. Only insured depositories can offer this product feature. The specific features of deposit insurance have been refined since 1933, including depositor preference and least-cost resolution methods. An active and informed debate is under way about the details of coverage and the management of the insurance fund. We will not delve into that today.

A second factor that may be nearly as important as deposit insurance is reputation. Occasional scandals have occurred, but banks have successfully retained their reputation for integrity when others have not. Even when structured transactions have tarred them, banks have remained well-regarded. Bank supervisors are well aware of the importance of reputation, and expect bank staff to manage the bank's risk of reputation just as they manage other risk exposures such as credit risk and interest rate risk.

Third, banks possess a remarkable advantage in their branching and product delivery capabilities. Let me take a few moments to emphasize that point. Branch offices and networks continue to be critical factors to customers as they choose their financial services providers.

Community banks continue to thrive by providing retail banking customers with convenient locations, high-quality service, and the attractive prices that customers desire. Surveys conducted by the Federal Reserve Board indicate that the single most-important factor influencing a customer's choice of banks is the location of the institution's branches. In the 2001 Survey of Consumer Finances, approximately 43 percent of households reported that the primary reason for choosing the institution where they had their main checking account was the location of the institution's offices. Likewise, data collected in the 1998 Survey of Small Business Finances indicated that, for approximately 30 percent of small businesses in the United States, the most important reason for selecting the primary financial institution was "location of offices" or "convenience." Consistent with these findings, responses to questions included in the Michigan Surveys of Consumers in June, July, and August 1999 indicated that the most important reason that households change banks is because of household relocation.

Other important factors underlying household choice of banks include low fees or minimum-balance requirements and the ability to obtain many services at one bank facility. For small businesses, the existence of a previous business or personal relationship with the institution or someone affiliated with the institution is a frequently cited reason for choosing a particular provider.

Once a household has chosen a particular depository institution as the location for its main checking account, there is a strong tendency to stick with that institution. According to the Michigan Survey, the median tenure at a depository institution is ten years. The most frequently reported reasons for remaining with a bank are customer service and location. Among those households that changed banks for reasons other than household relocation, the most frequently cited factors are better customer service and more attractive prices.

These patterns of behavior among households and small businesses bode well for the future of community banking. They do not suggest that community banks face any inherent disadvantage relative to larger institutions when it comes to attracting and retaining retail customers.

Bankers understand the importance of their locations. Despite the negative comments made for many years about the disadvantages of "bricks and mortar," the FDIC's Summary of Deposits has reported an increase in the number of banking offices each year since 1994. The asset-size profile of the industry has changed greatly over this period, so it is interesting to look at the average number of offices per bank in different size ranges. Banks having less than $100 million in assets average one to three offices, banks having $100 million to $500 million in assets generally operate five to ten offices, and so on. The larger the bank, the more offices it operates. As the industry has consolidated and created a greater proportion of larger institutions, the average number of offices per institution has increased. The data show that the increase in offices has come at the largest banks, that is, those with total assets in excess of $10 billion. Although the average number of offices has increased because of consolidation, there is evidence of a search for efficiency, as the number of offices per bank has declined noticeably across all size classes since 1994. The sole exception to this decline is in the largest size group. These large institutions operate on average, more than 400 branches, compared with about 240 branches in 1994. The Summary of Deposits data are published annually for June of each year. The latest available information is as of June 2003.

A fourth competitive factor favoring banks has been the use of technology. Banks were among the first businesses to migrate toward mass storage and processing of data, in part because this information was needed to meet regulatory and other requirements, for example, the loans to one borrower rule. Analysis and collection of this data has supported many important management and risk-management initiatives at banks, including the development and refinement of internal credit rating systems. Further investment in information technology capabilities may tap into other uses of this information to enhance the function and performance of commercial banks, including community banks, especially in the context of the Gramm-Leach-Bliley Act. Though community banks cannot invest as heavily in technology as large banks, the ever increasing efficiency of technology also works to the benefit of community banks. Newly chartered start-up banks are able to provide real-time online banking services to customers and operate general ledger systems that provide a full range of financial reporting and product support systems either through in-house technology or through outside vendors.

How has the Community Bank Adapted?

The number of banks has decreased, but the value of the community bank remains. Consolidation continued in the industry in 2003. There were about 7,300 community banks at year-end 2003, some 140 fewer (1.9 percent) than a year earlier and about 500 (or 11 percent) fewer than existed five years ago. The substantial majority of these institutions have been state-chartered.

We continue to see significant consolidation of organizations and of charters. This can be seen in the bank data already mentioned but perhaps more clearly in data on bank holding companies. Bank holding companies own nearly all of the insured commercial banks by assets, about 97 percent. The number of bank holding companies has fallen slightly--about 4 percent--over the past decade, but has increased a bit in each of the past three years. The number of multibank bank holding companies has decreased 30 percent over the past decade, reflecting the tendency of banks to consolidate subsidiary charters in this era of nationwide banking.

The consolidation in the industry, and the search for efficiency and scope, should not be misunderstood. It does not signal a threat to the community banking franchise; far from it. The market for community bank charters makes this point clear. One hundred and twelve new commercial bank charters were issued in 2003, and 560 have been issued since the beginning of 2000. Over that same period, for every five banks that disappeared through consolidation, another two new charters were granted. In total, that represents more than $4.5 billion in new equity capital invested in community bank charters.

Community banks have also been active in positioning themselves to diversify their business base. At year-end 2003, there were 4,800 bank holding companies with consolidated assets of less than $1 billion. Let's exclude the small number of foreign-owned institutions in that total, because their U.S. assets don't depict their true size. About 10 percent of these community bank holding companies (or 464) were also financial holding companies, and one-third of them had assets less than $150 million. Thus the financial holding company is as logical a successor to the bank holding company for smaller institutions as for larger institutions.

Community banks face some important and different realities, reflecting to some extent the change from protected markets to a more open and competitive environment. Their margins are more narrow, they have taken on a relatively larger share of commercial real estate credit exposure, and they have less chance of natural diversification in their lending opportunities. Concentrations of credit, especially in the local market, are a significant risk-management issue for community banks.

A Few Keys to Future Success

The competitive environment for banks, especially community banks, will continue to intensify. 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. The presence of large banking organizations at the local level has increased at the same time that community banks continue to face competition from thrift institutions, credit unions, securities firms, and loan production offices from out-of-market lenders, not to mention the Internet. Community banks can meet these competitive challenges.

One critical aspect of this success is for banks to minimize self-inflicted damage caused by conflicts of interest and lax internal controls. Compliance remains an important area of attention for many community banks, including compliance with regulations relating to money laundering and the Bank Secrecy Act.

On the topic of compliance, regulatory burden remains an issue for all of us to carefully consider. The federal banking agencies are fully engaged in continuing efforts to review their regulations and to identify those that can be eliminated. We at the Federal Reserve endeavor every five years to review all of our existing regulations to revise or rescind those that are out-of-date or otherwise unnecessary. Other banking regulators have adopted a similar practice. Many of you may have participated in meetings across the country between regulators and the community under the aegis of the Economic Growth Recovery and Paperwork Reduction Act, or EGRPRA. Some of the things we can do as agencies--some suggestions for revision--will require congressional action to change the law. But both regulatory and congressional efforts to eliminate unnecessary rules to protect the taxpayer are worthwhile.

Conclusion
The past year was a good year for the industry, one in which banks were able to adapt to a changing environment and still generate record profits. Community banks once again demonstrated their value to the marketplace and the prominent and vibrant position they rightly occupy in the industry. The anchors of their competitive position-- deposit insurance, reputation, branching and delivery system, and technology--remain in place. I am confident that community banks will effectively respond to changes in the competitive and regulatory environment. The fundamental management challenge is to balance the opportunities of the present with the prospects for the future.

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