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Trends and Issues in the Structure
of Commercial Banking

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Banking In Search Of An Identity

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I am pleased to have the opportunity to participate in this conference put together by President McTeer and his staff and the Center for the Study of Financial Institutions and Markets at Southern Methodist University. The program looks most interesting, and it is a good time to reflect seriously on the state of banking.

I want to add three basic issues to the discussion on banking in search of an identity:

1. The question of potential cost savings from large mergers;
2. The international competitiveness of U.S. banks and the related relevance of bank size, and;
3. Bank profitability in the current environment.

Let me begin with an overview, or perhaps even an understatement. The structure of the banking industry is subject to a high rate of change. In this environment of rapid change, it is useful to take a hard look at some of the issues involved in that change. For example, consider the issue of size of the industry. There were 100 new banks formed last year, even though 1991 was a recession year and many believe there is already overcapacity in the banking industry. Moreover, changes in the structure and regulation of the industry resulted in a 19 percent expansion in the number of branches in the second half of the decade of the 1980s. This expansion is especially notable since merging

banks often cite savings to be achieved by closing excess branches.

The change in the structure of the banking system is most obvious when we look at the expansion of interstate banking. In recent years, all but two states have acted to permit entry by out-of-state bank holding companies, and there are now over 200 multistate bank holding companies. In some states, very large percentages of total bank assets are held by banks owned by out-of-state bank holding companies. For example, here in Texas, over 40 percent of domestic banking assets are controlled by out-of-state bank holding companies. In the case of Texas, this is partly a result of regional economic difficulties, but nevertheless it represents a dramatic change in U.S. banking structure.

As you know, the Federal Reserve Board has supported the interstate banking movement. If the issue could have been considered by itself, the Congress might have enacted an interstate branch banking bill last year. I hope it will be addressed again soon. While we are moving in the right direction on the interstate banking issue, I believe we must make further progress on the deregulation of bank powers, a must if U.S. banks are to prosper.

Bank Mergers and Cost Savings

Turning to the first structure issue I want to discuss, the Board of Governors has approved a number of very large bank mergers in the past year. Even given my brief

tenure, I have had the opportunity to participate in the largest of these mergers, the acquisition of Security Pacific by BankAmerica.

Mergers can have negative connotations to the employees, the customers, or even some owners in individual situations, but they can also perform many useful functions. If there is excess capacity in the banking industry, mergers provide a means of exiting the industry. Historically, mergers have been the vehicle for removing weak competitors. As greater geographic expansion is permitted, they should provide a useful means for banks to achieve geographic diversification of loan risks.

Although mergers are a normal part of the market's functioning, as regulators, we are required to examine proposed mergers for compliance with various statutory criteria. We must be sure that the merger meets the safety and soundness criteria, the Community Reinvestment Act test, and the competitive standards.

Mergers are often proposed to achieve certain savings. If achieved, such savings would make the banking system more efficient and generally lower costs to consumers. But a basic question remains. Do mergers increase efficiency in the banking system? The evidence, so far, suggests that the answer, on average, is "no". The key point here is the "on average". Clearly, some bank holding companies appear to be able to engage in acquisition after acquisition while

lowering their operating costs and building their profits and capital.

We know there are banks that are able to improve the efficiency of banks they acquire, but studies examining hundreds or thousands of past mergers find that the average merger does not necessarily increase efficiency or profitability.

A recent study at the Federal Reserve Bank of Atlanta examined the post merger performance of all bank mergers that occurred between 1982 and 1986 involving banks with assets in excess of \$100 million. Four years after the merger, on average, the merged firm's ratio of noninterest expenses to assets was nearly 8 percent higher than it was before the merger. Much of this cost increase was explained by changes in overall industry costs and changes in bank portfolios. But, the authors concluded that there was no evidence that, on average, these mergers led to significantly lower expenses.

Why don't more mergers lead to gains in efficiency and profitability? Many mergers, of course, were not undertaken for the purpose of reducing costs. Some were designed to expand the acquiring bank's marketing range, some to eliminate a competitor, some to build an empire, and many for other reasons. Thus, to expect all mergers to have reduced costs is somewhat unfair.

Bank merger experts tell us that mergers should produce efficiency gains, but that bank managements may be

unable to capture the potential gains. Too often, a merger is on such friendly terms that no one is willing to make the tough decisions that lead to lower costs -- elimination of overlapping branches or merger of back office facilities and headquarters personnel. As one banker put it, "Every merging bank needs someone wearing a black hood."

There are other important factors involved in the merger issue. First, many believe that mergers will result in economies of scale. This may be the most studied question in banking research. Most of the evidence finds few scale economies at bank sizes above \$100 million. However, some of the more recent studies of megamergers find gains for bank sizes closer to \$5 billion. But, there is no evidence demonstrating that two \$25 billion banks are going to achieve scale economies by becoming a \$50 billion bank.

Second, in many mergers, the closing of overlapping branches is expected to lead to substantial savings. The studies of bank cost functions, however, suggest that the savings from closing branch offices are relatively small. The key point in costs is not the number of branches, but rather the volume of business that is conducted. If you close a branch and all of the customers are lost to your competitors, you indeed cut costs. Of course, you also cut revenues! If you close a branch and all the customers go to your other branches, the revenue stream continues, but so do most of the costs. Checks have to be processed, loan applications,

reviewed, and so forth. These functions create costs; labor is saved at the closed branches, but more people may be needed at the remaining branches, unless those branches were operating well below capacity before the merger. Because costs follow from providing services, the savings from closing branches may be less significant than many expect.

Although the evidence thus far does not support the argument that mergers consistently lead to greater efficiency, more work on the issue is being done at the Board and throughout the Federal Reserve System. Hopefully, in the future, we will be better able to understand the characteristics of successful mergers and the circumstances under which merger gains may or may not be achievable.

The International Competitiveness Issue

Given the size and importance of the American economy, U.S. banks are and should be major participants in international finance. Much has been written about the world status of U.S. banks and their nearly total disappearance from the lists of the world's largest banks.

Various American regulatory policies, which may be appropriate on other grounds, have constrained the growth of our major banks. Probably the most important of these policies is our past prohibition of interstate banking. If we had always permitted nationwide banking, our major banks would most likely rank higher in worldwide size comparisons.

Ironically, however, U.S. banks which are internationally oriented have been less active in interstate banking than the superregional banks. The superregionals, which have gained in domestic markets, appear to be more interested in building domestic nationwide banking organizations than in expanding abroad.

Turning to product line deregulation, we do permit an American bank to offer a domestically prohibited financial service abroad when that service is allowed in an overseas market. But, this is a limited exemption. And, we know that many U.S. banks still feel closed out of some foreign markets. If additional product line deregulation were allowed in the U.S., the relative size of American banks would likely increase and their world rankings should also increase. The gains here will accrue to those institutions with an international orientation because those banks have always held the vast majority of nonbank assets.

A removal of the prohibitions on domestic securities activities by bank holding companies would also strengthen the relative position of U.S. banking organizations. The Section 20 subsidiaries that are now permitted are a start in the right direction, but the repeal of Glass-Steagall would be a more effective means of increasing the competitiveness of American banking firms.

A question relevant to international competitiveness is, Does size really matter? Or, are the advantages of size

merely a matter of the market participants' perception of size and strength? Is a \$200 billion organization handicapped in competing with a \$400 billion bank? As I noted earlier, most studies do not find economies of scale for very large banks. Even the studies of the economies of superscale do not suggest that a \$400 billion bank would be able to produce at a lower cost than a \$200 billion bank. These are, of course, studies based on domestic data.

Is size the only factor that counts in international banking? No. Surveys have indicated that U.S. banks are highly regarded as professional and innovative. They frequently lead other nations' banks in the provision of newer high-tech services, such as interest rate swaps.

Except for LDC loans, American banks have found many of their international banking activities to be profitable. This is really the critical variable. Size may be a prestigious variable and provide broad name recognition, but profits count. Moreover, many of the largest foreign banks have not been as profitable as the U.S. banks.

Finally, I would like to cite one remaining problem facing U. S. banks in the international competition arena, the cost of bank capital. To be competitive, banks must be able to raise capital on terms not significantly worse than those facing their competitors. U.S. banks appear to be paying a premium for capital relative to their foreign counterparts because of the high federal deficit and regulatory costs

related to replenishing the deposit insurance fund and implementing the new bank legislation. (While I'm on that subject, many have already objected to the regulations implementing some provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991; the bad news is that there are more to come.)

To sum up some of these international observations, I think there has been considerable progress in resolving some problems facing U.S. banks operating overseas. Changes have been made to permit American banks to achieve the size that many perceive to be necessary to compete effectively in world markets. The Basle capital accords are helping to create a more level playing field, and will largely eliminate one of the factors that had been of concern to U.S. bankers. There are reasons to believe that, over time, there will be other areas of agreement that will provide increased consistency of powers and regulations between the major industrial countries. This, along with recent changes in international interest rates and relative stock market levels as well as international mobility of capital are even serving to narrow the costs of capital somewhat from country to country. But, certainly, more remains to be done.

Observations on Bank Profitability

A banking system can survive only if it creates an environment in which banks can earn a profit. But, making a profit requires more skill and effort than ever before.

Competition is keen, both between depository institutions and between depository institutions and other financial entities. Other than the provision of government-insured deposit accounts, there are no major financial services that cannot be provided by other institutions. Deregulation, innovation, and technology have produced the means by which many traditional bank customers can deal directly in the financial markets without the need for banks as intermediaries. When intermediation services are needed, they may come from nonbank financial institutions. Simply put, bankers no longer have a lock on the provision of banking services.

Given this change in the competitive environment, after all is said and done, profits will go to those well-capitalized banks that are able to evaluate and control credit risks and provide modern and innovative financial services at the minimum cost. Let me briefly discuss each of these factors.

Federal Reserve staff research suggests that well-capitalized banks have an advantage in the marketplace. Even though there is a safety net protecting most deposits and depositors, the bank with high capital levels appears to be able to attract funds at lower interest costs. Even insured deposits are more costly to obtain if a bank has a poor credit rating. More importantly, as banks increasingly compete for uninsured liabilities, the importance of capital strength will increase. But as always, capital is not a panacea, nor can it

ultimately protect a bank from bad management or the consequences of inadequate risk assessment. The bank that is viewed as a high risk operation will have to pay significantly higher rates for funds and, as a result, will not be able to earn adequate risk-adjusted margins on its loans and investments.

The evaluation and control of credit risks has to become the hallmark of the successful bank of the future. Many of the traditional functions of banks, especially those that involve processing activities, can be performed at lower cost by other firms.

Borrowers with unquestioned credit ratings can go to the market directly. So, the banks have to make a living by being able to evaluate the creditworthiness of less-than-perfect loan applicants. The banks' comparative advantage is likely to focus on a unique knowledge of the local banking market. The banks have to be able to provide outstanding services for the vast bulk of business and consumers that do not have ready access to the national capital markets. At the same time, competition will narrow margins, and it will be more important than ever to minimize loan losses.

In recent years we have seen too many banks, both large and small, assume loan risks that, especially in retrospect, are very difficult to explain. Commercial real estate loans quickly come to mind. Looking at the market for

commercial space in many cities, one wonders how all that excess capacity ever found funding.

Let me turn for a moment to cost control. Our staff research indicates that there are very substantial cost variations between banks of the same size. Some banks are simply more efficiently operated than others. There is no ready explanation for the cost variations that are found, other than good management is not equally distributed among banks. Clearly, the bank that wants to survive and prosper in the '90s knows where it should stand in the battle to control costs and evaluate risks.

Over time, many of the changes in banking have been used to argue that small banks cannot survive. The argument is often framed in terms of the small bank being unable to afford the technology or the staff necessary to maintain its competitiveness. Let's look at the small bank issue in terms of some of the factors that I have just been discussing.

First, small banks have typically been better capitalized than large banks. While small banks need higher capital than large banks to offset some risks not faced by large banks, most small banks were immediately in full compliance with the risk-based capital standards. Compliance has been a major effort for many of the largest banks.

Second, small banks know their customers well. They never were competing for the business of the Fortune 500 firms and had to be close to the business of the firms they served.

Fortunately, the customers that go to smaller banks seldom need the sophisticated, expensive-to-provide, high-tech services needed by large firms. Many customers still seem to prefer to deal with the locally based bank, where they have quick access to the top officers and receive prompt attention from people who understand their business and have followed its development over time. This will be a great advantage to the smaller banks in a world of interstate banking.

Third, small banks have been innovative over time. As is often pointed out, some of the major innovations in banking -- such as the NOW account -- have come from small firms. Small banks have adapted time and again to the technological changes that were supposed to have led to their demise.

Fourth, as I pointed out earlier, studies do not indicate that small banks suffer from significant cost disadvantages. Studies show that small banks are able to compete profitably in markets dominated by the largest banks and, on average, earn higher returns than the large banks.

Thus, the elements of change that I have discussed do not handicap the small bank.

Conclusion

In conclusion, while all size firms can survive and compete, I expect that the rapid pace of change in the structure of banking will continue. However, I anticipate that less of that change in the future will come from

institutional failures than in the past. Change, as it always does, will present challenges that will eliminate those who are unable to adapt. Fortunately, most of the rules for adaptation are old and well-known -- lending carefully at appropriate rates, controlling costs, assessing risks, aiming for profitability rather than size or market share, and being appropriately capitalized and innovative. There are not new ideas, but certainly ones that will ensure profitable survival in the times ahead.

I thank you for your attention.