

Speeches

Taking into Account a Changing World of Banking

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It's a pleasure to be with you today, especially in Savannah, the state's oldest city and its first banking center. To me, Savannah is a city that "gets it." I say that because the people here have managed to preserve what's important with the old while making some rather dramatic changes. It seems fitting that we're here in this modern hotel across from historic River Street to meet and discuss the very timely theme of change in banking.

Your conference asks the provocative question, "Has there been a more revolutionary time?" Before I venture to answer, let me make a few observations. As an industry, banking during the past twenty years has changed dramatically. There are many factors behind this change, but in my mind deregulation stands front and center. And during the next twenty years, I expect the evolution of financial services will dwarf the changes we've seen to date. Moreover, the recent shift from paper to electronic payments is unlike anything I've seen in my almost forty years with the Federal Reserve. So, looking at the broad scope of the financial sector, I think we'd all be well advised to follow the guidance of Jack Welch, the former General Electric CEO, who said: "Change—before you have to."

With that thought in mind, I'd like to start our discussion this morning with some observations on the financial services industry in general—both the challenges and opportunities. Then, I'd like to talk about the revolutionary change taking place with payments and how the Fed is responding with Check 21 and other initiatives. After my prepared remarks, I'll be glad to answer your questions on banking, payments, or the Fed's role in the economy.

A healthy banking sector

Of course, the Fed wants a healthy economy, and a strong banking sector is a cornerstone of a healthy economy. I'm pleased to report that the banking industry is looking pretty darn good—at least on the surface. As a bank regulator, I hope you really did not expect me to tell you that everything was perfect.

Over the past 10 years, total assets in the U.S. banking system more than doubled, from just over \$4 trillion a decade ago to \$8.5 trillion today. By comparison, the total commercial paper market is about \$1.6 trillion, and the corporate bond market is \$7.5 trillion. So, by most any measure, banking is big.

Growth in the banking industry continues, yet the number of institutions continues to decline. Last year, there were about 7,500 banks—down from nearly 10,000 in 1995. Although we keep losing banks to consolidation, investment capital keeps pouring into de novo startups. According to the Federal Deposit Insurance Corp., there were 111 new banking charters issued last year and 205 mergers. So on balance we lost some ninety-four institutions. As further evidence of the banking industry's vigor, the number of bank branches across the country—now nearing 80,000—continues to grow year after year.

As a regulator, I'm pleased to see that the number of problem banks is low, and the performance of existing institutions is high. For each of the past four years, the banking industry has reported record profits—more than \$100 billion in both 2003 and 2004. And while the final numbers for 2005 aren't available, I expect they will be equally strong.

Unique concerns of community banks

While your sector is thriving, I want to mention some unique concerns facing community banks. First, large banks continue to gain market share. While I know that's not breaking news, let me try to put the story in perspective. Ten years ago, small community banks with fewer than \$250 million in assets controlled 14 percent of all banking assets. By last year, the percentage of total banking assets held by the smallest banks declined by more than half. Meanwhile, large banks (which I will define as those having assets greater than \$10 billion) increased their share of total industry assets from just over 50 percent a decade ago to 75 percent today.

Despite these trends, small banks continue to be a competitive force. According to the Small Business Administration, one out of every two new jobs is created by a small business. By getting to know the needs of law firms, small retail as well as wholesale outlets, homebuilders, advertising agencies, and other potential customers, small banks have a great opportunity to leverage their competitive advantage.

This face-to-face approach to customer service has always been the strength of community banks, and I suspect the human touch will remain vital to your success—even with all the whizbang technology that seems to pop up wherever we go. However, I would caution you that emotional connection may not be enough to compete in today's economy, where everyone wants low-cost and high-performance—and they want it now.

Technological change

In addition to a loss of market share to your large bank counterparts, a second challenge facing many community banks is keeping pace with today's rapid technological change. The U.S. financial services industry is the most innovative in the world, but developing new products and services is often time consuming and resource intensive. With their deep pockets and staff, large banking organizations have the lead in the development of statistical modeling technologies to underwrite, securitize, and sell certain types of loans to the mass market.

Further, it's no secret that credit card lending is now primarily controlled by a few very large institutions. Other lending segments are also becoming increasingly commoditized. For instance, mortgage, home equity, small business lending—all are segments now peeling away from community banks. Again, it's technology that's providing the large organizations with economies of scale. They have established statistical scoring techniques that largely replace human judgment—at least in cases where the risks can be standardized.

Speaking of risk, risk management is another area of rising costs. To meet ever-increasing regulatory and market requirements, banks are forced to allocate more budget dollars to the protection of assets. But the story with community banks and technology is not all doom and gloom. Some impressive new risk management products are now available for smaller banks. Also, the Web can be a powerful tool to lower barriers and level the playing field. The Internet—available to everyone today—can be leveraged to attract new deposits, extend credit, and offer products and services most anywhere in the world. Thus, technology—assuming that it's developed and leveraged correctly—can help free banks from geographic bonds.

Regulatory compliance challenges

A third challenge facing banks is regulatory compliance. Change almost always has a cost, and that cost often falls disproportionately on small banks. The speed of change in compliance has been dramatic, and it's understandable why many bankers feel overwhelmed by mandates.

Staying mindful of our limited time, let me mention just a few recent changes in bank compliance that are probably demanding time and attention from your senior management and directors. The Sarbanes-Oxley Act of 2002 tightens standards for accounting and requires more disclosure on the part of public companies—including bank holding companies. As you know, the law also provides for much tougher penalties for executives and directors who participate in or even by default enable fraudulent behavior.

In addition, banks have to contend with Bank Secrecy Act (BSA) regulations that were added along with the USA Patriot Act. These new rules, which I know are time and resource intensive, are designed to prevent money laundering and funding of terrorist activities. Therefore, banks face additional responsibilities for knowing their customers and reporting suspicious activities. Again, we in the regulatory community understand the challenges of BSA compliance, and we are doing what we can to ensure consistency and clarity of expectations. While not perfect, the recently released BSA interagency compliance manual gives everyone the opportunity to work from the same playbook.

Another change I want to mention is depository insurance reform. The new law merges two funds but keeps the basic account insured at \$100,000 while holding the possibility of future increases. Coverage for retirement accounts was increased to \$250,000.

Finally, I thought I should also mention new data requirements for the Home Mortgage Disclosure Act (HMDA). Under this rule change, banks must now provide loan pricing information that can be used to determine whether there is discrimination in the higher-priced mortgage market.

A few moments ago, I alluded to the challenge of increasing competition while noting that larger banks now dominate credit cards and other lucrative financial services markets. But that's not the whole story. More and more corporate borrowers now go to capital markets to meet both their short- and long-term financing needs—either through the commercial paper market or the bond market. As a result, banks' share of the commercial lending market for the past several years has eroded.

Residential lending growth

So what's left for you? Well, the numbers tell us that small banks have rediscovered a significant source of growth and revenue—and that's in residential real estate. It's no secret to any of you when I say that housing has been a growth industry in recent years. Since 1995, private residential investment increased from 4 to 6 percent of U.S. gross domestic product and last year stood at about \$750 billion. Smaller institutions often enjoy local knowledge and expertise in real estate, and they have absorbed a considerable portion of the lending to support housing activity. By the way, I trust that you are thoroughly reviewing all of these loans and the quality of assets behind them.

It will also come as no surprise that banks in the Southeastern United States tend to have the highest real estate lending concentrations in the nation, rivaled only by banks along the West Coast. This makes sense given the continued in-migration to the region from northern retirees as well as from Latin America. As our population grows, so too does the need for housing. And, as they say in the real estate business, "retail follows the rooftops." So, as the housing stock grows, the need for new retail, office, and industrial space also expands. And it follows that banks in the Southeast are seizing the opportunity to finance this growing sector of our economy.

In Georgia, housing has been strong but not spectacular, with existing home prices appreciating statewide in 2005 by about 6 percent. But in Florida, which adds about 400,000 new residents every year, housing prices in 2005 appreciated more than 25 percent. It's no coincidence that Florida is also going through a boom in the startup of community banks. Everyone wants a piece of the real estate pie, at least while it's still available.

So loan growth is good. But let's remember that old adage, "if something seems too good to be true, it probably is." Some easing in the growth of housing construction, sales, and price appreciation is likely to occur at some point—if not already. And banks that are overextended in real estate lending could be vulnerable to unpleasant surprises. No doubt much has improved since the savings and loan crisis of the 1980s. But those of you who were in banking then will know what I mean when I say: proceed with caution.

Emerging competition

Since our theme is change, I'd like to make one more point about competition. Not only do banks face mounting pressures from large institutions, but also they confront more and more nonbank competitors.

For instance, the online payments marketplace is booming. After less than a decade in business, PayPal now claims more than 100 million accounts. But now Google reportedly is joining the fray with a new service called GBuy. Various banks and credit card providers are also rushing for an angle into this growing segment of online financial services.

And you have retailers experimenting with new payments options as a way to avoid paying fees for credit card transactions. We are seeing store-issued loyalty cards that let customers debit money directly from their bank accounts via automated clearinghouse (ACH), which I'll discuss more in a moment. As their marketplace matures, even cell phone companies are reviewing their options for moving into payments as a new source of revenue.

Some of the competitive challenges are familiar, and others are relatively new. For many years, credit unions have enjoyed certain tax advantages. More recently, automakers and other businesses including major retailers are going head-to-head against banks in profitable segments such as vehicle financing. Assets controlled by businesses with so-called industrial loan charters (ILCs) have increased from \$3.8 billion in 1987 to about \$140 billion in 2004—a development that concerns many bankers, especially in smaller markets. The bottom line: You face an influx of tough and savvy competitors going after your best customers.

Changing payments landscape

Payments is another area going through revolutionary change. In this arena, the Federal Reserve has an important role to help foster a safe and efficient payment system. One of the ways that we do that is to provide certain types of financial services—namely check, ACH, cash, and high-dollar wire transfer processing services. In this regard, the Fed is committed to promoting efficiency, both inside our organization and throughout the financial services industry.

For many years, our organization has dedicated vast resources to processing checks as efficiently as possible. But in recent years check volume has declined by roughly 5 percent a year. At the same time, debit cards and various types of prepaid card payments have grown rapidly. In 2003, for the first time ever measured, the number of electronic transactions exceeded the number of checks processed.

As Americans write fewer and fewer checks, the volume of ACH transactions is increasing. In 2005, ACH volume stood at close to 11 billion items and is growing annually by about 15 to 20 percent. A big part of the growth in ACH is the conversion of checks to ACH debits, either at the point of purchase or at so-called lockboxes. In 2005, there were an estimated 3 billion of these check-to-ACH and eCheck items, which include Web and phone payments. That number represents a 50 percent increase over 2004, and I think this growth rate will be even higher in 2006.

With this transition in payments, banks and regulatory authorities must address new concerns, including electronic fraud and identity theft. Security is a priority for the entire financial services industry, but I'm pleased with the Fed's leadership to address this critical issue as it relates to ACH transactions through several new risk management services.

As the range of payments options continues to expand, we recognize the need to adjust our infrastructure. Today the Fed System is in the process of reducing the number of check-processing facilities from 45 to 21 by the end of next year. Yet, with the increasingly global nature of our economy, the Fed also has introduced new methods of making electronic payments overseas, including the extension of ACH services to Canada, Mexico, and parts of Europe.

Check 21 progress

Recently, we took what I have described as a big step forward in payments technology with the Check Clearing for the 21st Century Act, which most of you may know simply as "Check 21." As you know, Congress passed Check 21 in 2003, and the program went into effect in October 2004. In short, this law facilitates the shift to electronic check collection by allowing—without requiring—collecting banks to create and send electronic images of the check. The law, however, also lets the paying bank choose whether to accept that electronic image or require a paper substitute.

A little more than a year after the implementation of the act, there are now more than 500 banks using Check 21 at the deposit end, and the Fed is processing roughly 2.5 million Check 21 items on an average day worth some \$13 billion. By the end of 2006 I expect there will be 1,000 banks using Check 21. Moreover, the average check value in the past year declined from about \$18,000 to less than \$6,000 as banks increasingly use Check 21 as a substitute for slower and more cumbersome courier delivery of check bundles. All in all, we're pleased with the progress of Check 21, and banks seem to recognize the value of faster availability.

All of us want to see a swift and painless transition from paper to electronics. But we know the reality is more complex. Many organizations have multiple processing platforms or excess capacity. Quite a few financial services providers are stuck in the rut of encouraging customers to write paper checks to attract deposits—and at the same time striving to convert the back office to electronics—a pretty conflicted strategy, in my opinion.

While some organizations continue to depend on float as a source of revenue, I'm glad to see many smaller banks enthusiastically embracing our Check 21 and check conversion programs that reduce float. My point is, payments efficiency is another area where you can gain a competitive advantage—as long as you embrace change and act decisively.

The late science fiction writer Isaac Asimov—a man with unique insights into the future—many years ago described change as "the dominant factor in society today." And then he added: "No sensible decision can be made any longer without taking into account not only the world as it is, but the world as it will be." I'm not here to tell you what decisions to make, but I do hope you act on what you learn at this conference.

To summarize my remarks, I believe the banking industry is doing well, but there are some hazards lurking below the surface, especially for community banks. These challenges include effective use of technology, additional compliance costs, and increased competition from larger institutions. And we must not forget those nonbanks that are moving aggressively to capture the most lucrative segments of the rapidly growing marketplace for electronic payments.

It's your job to define your competitive advantages and then find the will and the means to push hard in the right direction. Building ties in the community is a good way to start but may not be enough for long-term success. So, in keeping with the theme of this conference, your task is to respond to change and think of your world "as it will be." I fully expect that world will be fiercely competitive, more globally interconnected, based on electronics instead of paper, and no doubt highly efficient. Banks must also leverage the personal touch. In short, you must provide the best of both worlds, the best of the old and the new. Your success—your very future—depends on your decisions as we go through this time of revolutionary change.

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