

THE FUTURE OF SMALL BANKS

Remarks of
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Today's rapid and unnerving changes in the financial services environment are creating headaches for many smaller, independent banks. Just look at what market forces, Congress, and regulators have done to the small bank lately. Interest ceilings on time deposits have been virtually eliminated. Big nonbanks and banks alike have entered your markets more and more often to compete for all kinds of business. And more competition is on the way.

Savers can find deposit accounts that mature at seven days with no interest ceilings or minimum deposit requirements; the individual who deposits a minimum of \$2,500 in a transactions account will find no regulatory ceilings on the amount of interest the money will earn. While every commercial bank deposit was subject to interest rate controls in 1963, the proportion had plunged to 87 percent 10 years later and to about 40 percent last year.

These are indeed traumatic changes for smaller banks facing stiff competition from larger institutions. Of course, this loosening of the old restrictive regulations also frees banks to compete more aggressively, with few holds barred. But certainly it offers no guarantee of success in the new financial environment. All of you have watched your cost of money escalate while your share of a growing market for funds has declined.

Smaller banks have seen their customers and deposits diverted by the attractiveness of money market funds, which maintained their hold on more than \$175 billion at the end of 1983 after a year of banks' decontrolled competition. One of the money market fund giants, Merrill Lynch, recently counted total CMA assets of \$75 billion and claimed 940,000 CMA accounts.

Formal deregulation has taken acknowledgement of market forces by lowering interest rate barriers, but interest rate regulations have not been the only area affected. Other barriers, too, have begun to crumble. Large commercial banks have breached state boundary lines and have tapped your local markets by means of loan production offices, Edge Act corporations, and nonbank subsidiaries of bank holding companies. These provide banking services unhindered by interstate restrictions. Research that we have done at the Federal Reserve Bank of Atlanta identified some 8,000 interstate offices of banks and bank holding companies, concentrated in California, Texas and the Southeast. More than 270 of those offices were operating in Georgia when we conducted a survey early in 1983.

Public announcements have made us aware of at least 18 bank ownership links that have been forged so far across state boundaries, and mergers have produced 20 large interstate thrift institutions.

Nondepository institutions have also expanded their financial services into interstate markets, using a wide range of combinations and innovations. The most recent wave of these have involved nonbank banks which the Federal Reserve is trying — manfully but with less than complete success — to rein in.

If anyone had asked you 10 years ago if small banks could survive all of these challenges, I think you would have had your doubts. Yet, here you are, still bankers, and — most of you, at least — still earning good profits. In the face of all this, it seems quite remarkable — and a tribute to the nation's bankers — that banks have

continued to earn very respectable profits. Perhaps in view of this uncertainty a brief summary of the profit picture will be reassuring.

Between 1970 and 1982, while the average annual CPI rose about 242 percent, the after-tax net earnings of commercial banks rose over 310 percent, from about \$4.8 billion to about \$14.9 billion. During the first half of 1983, despite the introduction of the MMDA, banks matched first-half 1982 returns on assets and equity and increased their net interest margin. Understandably, that sort of profitability whetted the appetites of those nondepository competitors to challenge your markets.

You have held onto a substantial share of the nation's credit business; commercial banks' share of total credit extended by private financial institutions in the United States was almost the same at the end of 1983 as it was two decades earlier — something under 40 percent. You have survived a great deal of both market-generated deregulation and formal deregulation. You have demonstrated that you have the necessary skills and character to cope with constant, radical and sometimes unpredictable change. The fact that you are still here suggests that you have what it takes to be here in another 10 years, still successful bankers.

Some banks, of course, may consciously decide not to survive, opting for a merger instead. Even so, to attract favorable merger proposals they will need to do many of the same things that will have to be done by the banks that do choose to survive.

Different types of banks will face different types of problems as they contemplate the future. Banks seem to fall into three broad categories — giant, regional, and community institutions. In the time remaining, I want to concentrate on community banks — their problems and their potential.

The so-called "community banks" are often said to be the most vulnerable in a deregulated environment. Yet many recent studies suggest they may be less so than regional banks that either draw the stiffest competition or attract the most tempting and insistent merger proposals. Those studies indicate that — except for the "compliance

costs" of abiding by consumer regulations — the community banks are not at a cost disadvantage. In fact, studies indicate the smaller banks have actually been gaining market share vis-a-vis larger local competitors. The future many of you face would seem at least as promising as that of the larger banks.

A look at the New York City banks' experience in upstate New York is instructive. Most of the big, scary money center banks entered metropolitan areas in upstate New York in the early 1970s. By 1980 their average market share gain was 1.3 percent, hardly a sterling performance.

Banks can do several things to improve their chances of surviving the coming phases of deregulation. If you will allow a central banker to offer some suggestions, I would like to share some of my thoughts with you. Since you obviously are already survivors, in our special sense of the word, the tips I am about to offer may seem to be stating the obvious. However, perhaps they will at least reinforce the survival skills that have kept you in the race so far.

Careful strategic planning and action are essential. You must foresee the major changes in your environment, and you must be alert to both the opportunities and the risks created by those changes. But beware of bandwagons. For example, many banks have been positioning themselves to serve up-scale retail customers and middle-market businesses. Not all banks can do this; for a variety of reasons, some banks enjoy special advantages with regard to this market, and the market itself is not big enough for all banks to share. If you are going to ride a bandwagon, get on early, establish your position and then maintain it.

Beware of being all things to all people. Supermarkets are fine but their margins are small. Further, there is little evidence that combining many financial services under one umbrella will be successful. You might start thinking about this by asking what kind of customer service rep can handle banking, securities and insurance, as well

as other peripheral businesses.

You must also know your market. That means not only knowing the characteristics of your market today, but also knowing — with reasonable certainty — what those characteristics will be next year. For example, you must keep in mind that tomorrow's customers are students who are doing their homework on computers and playing computer games today. They should be thoroughly comfortable with EFT, direct deposit of payroll, bank-at-home computer terminals and other technological advances that may make their parents a bit uneasy.

Your present customers' loyalty may give you a solid base today but your future will depend on your ability to attract the loyalty of customers with quite different preferences. Another source of future customers may be those who have been abandoned by your competitors. You will need to determine, of course, why they were abandoned; they may have proved unprofitable, or the bandwagon may be running away from them. Either way, you may be able to find a new way to make them profitable members of your future base.

Community bankers, in particular, should explore the possibilities of networks and service bureaus. They can give you the advantages of scale economies, because they can spread fixed costs. Networks and service bureaus may help you stay in the game with the big banks. They can protect your capital. Let those larger banks make the big investments in sophisticated equipment while you conserve your capital for more basic banking needs. This can also contribute to your flexibility by sparing you from committing your bank to expensive hardware that may become outmoded before it has been fully depreciated. Flexibility is an important asset in adapting to constant change.

Be sure you have a highly motivated, competent, productive staff. Controlling interest expenses will be a key to profitability. Unhappy employees can sap a bank's

vitality; even responsible employees may become less productive as they come to resent those who drag their organization down. Performance-based incentives are the key to success here. For example, some banks have involved all employees in a permanent program that compensates them in cash for deposit accounts. This motivates everyone from tellers to computer operators to attract the core deposits on which most banks depend.

Bankers should support legislative change that broadens their powers. It is futile to hope for protective legislation; today's legislators may want to slow change, but they are unlikely to favor more protection except in a crisis. More important, our recent experience tells us the market probably would find loopholes in any protective legislation. When protective measures are skirted by nonbanks, all banks lose. When banks' powers are broadened, on the other hand, some banks certainly may lose, but others — those of you ready to take advantage of new opportunities and to minimize unfamiliar risks — will gain.

Beware of bricks and mortar. The elimination of interest limits has reduced the importance of convenience as a competitive tool. When interest on demand deposits becomes fact, convenience will become even less critical. Even more significant, however, are the technological developments that have moved us toward electronic delivery systems for financial services. When the "Pac-Man generation" comes of age, full service branch offices will become much less important.

A bank whose stockholders clearly perceive that they have a real stake in its survival has an important advantage. If your stockholders are local business and professional people who see their bank benefitting them and their community more than a successor would, a merger offer is more likely to be given a cold shoulder.

Finally, always remember that, during periods of rapid change, there is a real premium on skillful management. Be sure you and your associates are continually upgrading your skills and information. Innovative management can find ways to cut

costs, minimize risks, improve services, and quickly see and exploit the new opportunities that will be arising as a result of change.

Those are some of the things commercial bankers can do to survive if that is your choice. But you will have to work at it, since you will be facing stiffer competition from a wider variety of sources than ever before in the past.

And you will have to accept the necessity of change. The bank that tries to stay in business by doing the same old things in the same old way is least likely to be doing anything at all 10 years from now.

Foreseeing and taking advantage of the opportunities created by change can enable a bank not only to survive but to thrive. Skilled management is the key.

And I wish you all the luck in the world as you meet that challenge.