

**THE FUTURE OF THE FINANCIAL SERVICES INDUSTRY AND THE ROLE OF  
COMMUNITY BANKERS**

**Remarks of  
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to the  
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It's a real pleasure for me to be here with you this morning to lead off the twentieth anniversary of your Spring Presidents' Forum. Your meeting's emphasis on improving profitability and developing new products is a very timely one in view of the fast pace of change and the intense level of competition that have become prevalent in banking today. I would like to talk about the future of banking and of financial services, in general. In that context, I'll have some comments on the role of community banks in tomorrow's financial services industry, and what some of the critical success factors might be.

**Banking—Today Versus Yesterday**

Let me begin by telling you unequivocally that community banks are here to stay! Certainly, mergers and consolidation are likely in the banking industry, but, in my opinion, community banks will continue to play an important role in America's evolving financial system. Obviously, banking has changed enormously over the past 15-20 years, and, in my judgment, this transformation is by no means over or at a plateau. The industry as a whole and many individual banks, in particular, will face many significant competitive challenges, even threats, in the years ahead. Still, most banks can thrive and prosper if they have the desire to succeed.

In order to see where banking is headed, I think it's a good idea to look around and see where we stand today compared with, say, the situation 10 years ago. If a

banker whose work experience spanned the decades from the 1930s to the 1960s were, like Rip Van Winkle, to awaken today from a 20-year slumber, he would scarcely recognize his old profession. This old-timer would discover that while he was napping, market forces had changed the regulated world of the past into one that requires much more creativity and less adherence to procedures. Not many years ago, the world of depository institutions was surrounded by a fence posted liberally with "no trespassing" signs. Within that fence were walls that neatly segmented the various types of depository institutions. You could tell them apart a mile away: savings and loan associations could not offer checking accounts or anything resembling them. Neither could credit unions. Commercial lending was reserved strictly for bankers, but virtually all aspects of investment banking, including brokerage services, were off-limits to commercial banks.

The institutions within that fence were closely regulated. Rigid limitations restricted their freedom to establish branches or other offices, and banks' markets were generally confined to their own states or even to certain counties or regions within those states. Other inflexible restrictions regulated their ability to expand product lines. Legal ceilings created a cap on the level of interest rates they could pay on various kinds of deposits, dampening any competition that might emerge. During this long period of shelter from outside competition, financial institutions were almost guaranteed a profitable operation if they complied with regulations, did their arithmetic carefully, and offered a reasonable level of service to their depositors. Banks did not chafe at their geographic limitations, or they did not mount pressures to remove such limitations, in large part because their local and state markets tended to provide good profits within the sheltered regulatory environment. Competition within the enclosure was muted, and banks' potential competitors showed little desire to offer banking services, and, thus, penetrate the regulatory fence. The friction introduced by interest

ceilings made the situation appear stable for a while since these ceilings deterred nonbanking financial institutions from entering the markets traditionally dominated by banks.

Today, the situation is quite different. Some gaping holes have been punched through that once-protective fence. Many of the "no trespassing" signs have been trampled down, and the walls within that fence have been breached so often that many depositors forget they ever existed. The first major change to occur was in the type of businesses offering financial services. Beginning in 1973, Dreyfus, Merrill Lynch, and other nonbanking financial service companies began offering money market mutual funds. These interest-bearing deposits were a close substitute for bank deposits, and their popularity accelerated sharply in the latter half of the 1970s. Not only have nonbanking financial institutions played an increasing role in the line of commerce once the exclusive domain of banks. In addition, even nonfinancial companies, such as Sears and the finance company subsidiaries of GM, GE, and other manufacturers have expanded beyond their traditional roles of financing the products of their parents and are competing more and more in the markets once dominated by commercial banks.

Another major change, and one that was led by banks, was in the area of geographic expansion. Interstate banking has been spreading rapidly. By the end of this year we will find banks from about one-third of the states operating deposit-taking offices across state lines in at least 40 states. What's more, individual states have adopted laws that allow out-of-state banks to operate within their borders, further weakening geographic limitations. In all, 23 states have approved laws of this type. The best known are the 10 states that have adopted regional reciprocal interstate banking laws. These states are concentrated primarily in New England and the Southeast.

This geographic and institutional expansion of financial markets has occurred in tandem with product expansion. Institutions have bypassed the old restrictions on product lines. Banks and thrifts have the money market deposit account and the Super NOW account with which to compete against money market funds, and they have had some success in drawing back deposits formerly lost to CDs offered by nonbanking financial institutions. In addition, some banks offer discount brokerage services. Thrifts and credit unions offer checking accounts, and a myriad of financial instruments and services are available to the consumer.

A final major difference between today's and yesterday's financial services industry pertains to the character or style of business. The financial services industry seems to have lost some of its staid and stable character. In the last two years the number of bank failures has increased sharply, from about four per year in the sixties and about eight per year in the seventies to 48 in 1983 and 79 last year. These failures occurred at FDIC-insured commercial banks. More recently one of the nation's largest banks virtually failed, and in the last few weeks problems with S&Ls in Ohio have worried depositors and financial markets here and abroad.

### **Forces of Change**

How did all this happen? How and why did our traditionally conservative sector of the economy undergo such dramatic changes in such a short time? As I see it, three fundamental forces account for these changes. These are inflation, technology, and competition, with its attendant pressures for deregulation. Market forces and inflation deserve much of the credit—or blame, depending on your perspective—for interest-rate deregulation. The acceleration of inflation in the 1970s began to make bank accounts, with their interest rate ceilings, look less appealing to depositors. Who

could get excited about earning  $5\frac{1}{2}$  percent when inflation was shrinking the buying power of deposits faster than the accrued interest increased their nominal value? Investors sought and found opportunities to earn more. Some unregulated and quite innovative businesses on the other side of the fence recognized the opportunity and conceived the money market fund.

Since those outside businesses were free of the regulations limiting banking institutions, they could offer depositors market rates of interest on funds placed with them. The result was inevitable: investors searching for more lucrative returns began to remove their deposits from depository institutions and to swell those money market funds. The fence that once seemed to shelter the regulated depositories quickly began to look more like a prison wall. Bankers could not win at their own game.

Banks' competitive problems generated momentum for the drive to liberalize government regulations. Many regulatory restrictions have been eliminated. Today, the deregulation of interest rates on deposits is virtually complete. Only passbook savings accounts, NOW accounts, and, of course, demand deposits are limited by interest ceilings. These accounts make up less than 40 percent of total commercial banks' deposit liabilities and only 18 percent of interest-earning deposit liabilities. Ceilings on all interest-earning accounts will be eliminated on or before March 31, 1986.

Deregulation and innovation are also eroding barriers to interstate banking and product diversification. Although the legislative barriers to interstate banking still stand, banking across state lines has, nonetheless, emerged as a marketplace reality. Through a variety of stratagems—including such devices as loan production offices, bank holding company subsidiaries, and the so-called "nonbank banks"—firms ranging from

banks and thrifts to supermarkets and general merchandisers are offering a mixture of financial services through offices scattered from the Atlantic to the Pacific. If we count the number of offices of foreign banks, Edge Act corporations, loan production offices, and other nonbanking subsidiaries of banks and bank holding companies as well as grandfathered interstate banking offices that are operating across state lines, the number of interstate offices offering various types of banking services totals almost 8000! When you compare this figure to the number of commercial banks in the United States—a total of 15,000 with 55,000 offices engaged in full-service banking, you can see that we have an enormous amount of interstate banking already.

Some of the latest proliferation of interstate banking offices has occurred as a result of a Congressional loophole—the 4 (c) 8 clause of the Bank Holding Company Act that defines a bank as an institution that accepts deposits and makes commercial loans. Some financial corporations interpreted that clause to mean that subsidiaries which engage in one, but not both, of these two functions could legally offer such services across state lines. This either/or interpretation gave rise to the term "nonbank bank," with which you're all now quite familiar. I sometimes awaken from a dream, or perhaps a nightmare, in which a non-Fed Fed is trying to oversee these nonbank banks. After a lengthy period of legal wrangling, and after it became apparent that Congress was not likely to address the issue anytime soon, the Comptroller of the Currency last fall approved a number of long-pending applications for nonbank bank charters. Over 100 were subsequently approved by the Comptroller, the chief regulator of national banks. However, a suit by the Florida Independent Bankers Association challenging the jurisdiction of the Comptroller over nonbank entities has brought the former flood of approvals to a standstill, and the status of nonbank banks remains in legislative and judicial limbo.

Our legislators in Washington and in state capitals may debate the merits of these trends for a few more years, and they may influence the speed and course of interstate banking. Nonetheless, it is probably too late for legislators to stem the tide of interstate banking that is being propelled by underlying market forces. The same is true of the judicial decisions pending. Early in 1985 the U.S. Supreme Court agreed to determine the constitutionality of state banking laws that limit interstate mergers to certain other states. The case before the Supreme Court was filed by Citicorp and New England Bancorp of New Haven, Connecticut. They are challenging the Federal Reserve Board's approval of mergers under state laws that limit such mergers to states participating in the New England regional interstate compact. That is of particular interest to us here in the Southeast, of course, but this decision will also be watched closely by legislators from other states such as Oregon, where regional interstate banking is under contemplation. It could have implications for the merger of Florida's Sun Banks and Trust Company of Georgia as well since Citicorp has also filed suit in the U.S. Court of Appeals for the Second District in New York to block the SunTrust merger.

It is difficult to predict when the Supreme Court's ruling may be issued although present indications are that a decision could be forthcoming by July. Even if the case were delayed until the fall term in October, however, interstate deposit taking would not necessarily slow. A recent Federal Reserve Board proposal to allow bank holding companies to provide certain administrative and back-office services to their nonbank bank subsidiaries would sustain the expansion of interstate deposit-taking even without regional compacts. This proposal could give new legitimacy and efficiency to out-of-state nonbank banks by including data processing and bookkeeping services under the umbrella of activities that nonbank banks would be allowed to perform. This proposal would also permit holding companies to share officers and directors with their nonbank

subsidiaries. In addition, the proposal would preserve any trust service agreements between trust companies and subsidiaries converted into nonbank banks. This proposal is still just that—a proposal. Yet, its consideration by the Fed reflects the strength of competitive market forces that are working toward greater efficiency in the financial services industry. Thus, its existence even as a proposal implicitly provides further evidence that interstate banking is here to stay.

At the same time that deteriorating legal barriers and intensifying competitive pressures have been transforming the financial services industry in dramatic ways, a revolution has been taking place in our payments system and, thereby, contributed significantly to changes in the nature of banking and other financial services. ATMs and other computerized services put customers and banks in touch more quickly without the personnel and capital expense of bricks and mortar branches. Thus, the physical branch system of banks and S&Ls, one of their unique features, has become less significant. Moreover, banks' direct access to the payments clearing mechanism has lost some of its importance. Although checks and cash will remain important into the foreseeable future, paperless transactions involving wire transfers and automated clearinghouses are growing far more rapidly. Networks linking automated teller machines are offering consumers unprecedented convenience. For example, travelers a thousand miles away from home can withdraw or borrow cash after banking hours. When you stop to think of it, you cannot help but be amazed by the sweeping changes that have taken place. Those ahead may be still more amazing.

### **The Future of Financial Services**

Where is banking going and what is it going to be like to do business in a bank of the future? As I see it, four major forces will shape the course of tomorrow's financial services industry. These are macroeconomic growth, further increases in competition, regulatory changes, and even more exciting technological innovations. Clearly, macroeconomic factors will play an important, and I believe positive, role in determining the direction taken by banks, thrifts, and other financial institutions. Provided progress can be made toward lowering the very large federal budget deficit, the U.S. economy is likely to grow at a sustained strong rate over the next decade. This growth should help mitigate problems such as the high incidence of bank failures. This expected expansion will also increase demand for all kinds of financial services, thereby creating an environment of growth and opportunities for bankers like yourselves.

Since this sort of macroeconomic growth will require a stable as well as a highly developed and responsive financial system, we will probably experience some changes in the regulatory environment to ensure the continuing soundness of our financial system. Increases in bank capital ratios have already been enacted. We may see a change in deposit insurance to a tiered system. Critics of the present system have proposed deposit insurance fees based on bank risk, strict limits on payoffs for failed banks, private co-insurance, and more intense supervision. The thrust of recommendations put forth by regulatory agencies other than the Federal Reserve is to place more risk on depositors. Under these various proposals, depositors would bear more of the cost of bank risk either because banks would be charged for their riskiness and pass the added costs along to customers or because insurance coverage would be limited. In either case, more of the burden of assessing risk would fall on banks' customers. None of

the proposals is free from bugs; none is terribly attractive. I believe that there will be some reform, however.

Notwithstanding the probability of some regulatory reform, I believe that the major thrust will be toward further deregulation. Laws and regulations, no matter how well thought out, are proving to be flimsy indeed when pitted against market forces that push money flows into their most profitable uses. Within five to seven years, I feel, banks will be able to operate across state lines nationwide, and new powers will enable banks to offer customers a wider range of services. Competition within the banking industry will be strong as banks enter new markets. External competition will continue from Sears, Kroger, Merrill Lynch and others, as well as from savings and loan associations and foreign institutions.

In addition, consolidation of institutions will continue or even accelerate, although I doubt that U.S. banking will be dominated by a handful of large institutions as is the case in Canada and certain other developed countries. Banks in the \$2 billion to \$10 billion asset-size category, like the larger institutions in the Southeast, probably will find it more difficult to compete than either the small community banks with carefully defined niches or giant money center banks with their vast resources. The type and size of America's financial institutions will remain varied because beyond the range of \$75-100 million in assets, economies of scale apparently begin to diminish significantly. Furthermore, large banks have not significantly penetrated the markets or slowed the growth of smaller institutions when they have entered into direct competition. One reason is that small institutions can offer many of the same high volume services as large institutions through the vehicle of franchising. Franchising relationships enable small institutions to provide many of the low-cost services available at larger, more

bureaucratic financial institutions without diminishing the special features that distinguish small institutions from larger ones.

Will the likelihood of further mergers and consolidation, even allowing for a continuing role for small, independent institutions, leave some communities capital poor? I seriously doubt such a development would occur. Money goes to wherever it can earn the highest rate of return. We already have national capital markets. The fact that we do has been important in maintaining small, independent institutions since these national capital markets provide them a source of funding for local projects and a means of expanding their own sources of revenue beyond the local loan market. Smaller, independent banks are also well positioned to assess the profitability of community investments. I'll have more to say about this aspect of banking in a moment when my comments turn to the future of community banks.

Before I do, though, I'd like to point to one final force for continuing change in the financial services industry, to wit, technology. The wave of new technology will allow banks, both large and small, to operate more efficiently, substituting ATMs, point-of-sales payments systems, and the like for brick-and-mortar branch offices. Home banking, utilizing the family's personal computer, may also become a reality as technological advances make it cheaper and more affordable to a wide range of households.

### **Role of Community Banks**

What do community banks need to do to succeed in tomorrow's environment? First, you need to muster self-confidence by recognizing your current strengths—high

profitability, lower risk as measured by capital ratios and liabilities, and a core of trusting relationships with your customers. The proliferation and declining costs of technological changes are also working to your advantage by rendering the benefits of such innovations more available to institutions of all sizes. Shared ATM networks are following the path of other financial products like travelers checks, which did not long remain in the purview of large institutions.

A second ingredient for success should be defining your goals clearly. The fundamental goal of community bank management, in my opinion, is to maximize shareholder value. This is true whether you want to continue in the banking business or to sell out to a larger concern because the attainment of this goal simultaneously creates the largest premium for a would-be acquirer and builds the strongest foundation to remain independent or to acquire other institutions if desired. Maximizing shareholder value means seeking the highest possible return on assets and equity. For community bankers, achieving this goal will require a strategy of excelling at basic banking.

What is basic banking? Matching suppliers and users of funds as well as matching maturities of transactions. It means providing a reliable payments system, including the issuance of accurate statements to your clients. For community banks, basic banking also entails assessing the risks of local projects better than the branch manager of a large money-center or out-of-state bank can do. Many of you have lived in your communities all your lives. You know the people applying for business loans like no one from outside your community can. You also have an intimate knowledge of your local economy, and this familiarity can help you evaluate the economic worthiness of projects in a manner that goes beyond the abstract facts and figures on a piece of paper on which a larger, nonlocal bank would have to rely exclusively. This special

knowledge you possess should enhance your already strong image as a provider of community services, as a community builder. This fact is another reason, in addition to those I mentioned a few moments ago, for me to doubt that interstate banking will draw capital out of certain localities. Finally, the community banker may well have the broad perspective regarding costs and returns that should translate into greater profitability for the organization as a whole; in contrast, the specialization of larger financial organizations often results in a narrow point of view, whereby division costs are minimized or sales of a particular service are maximized without full regard for the effect of such operations, with their associated transfer pricing, on the whole organization's bottom line.

Besides focusing on basic banking in order to maximize returns, community banks should also adopt a strategy of competing on the quality of their services in addition to price. It will take a "sharpened pencil" and all the incisive analysis which that term implies to keep abreast of the constantly expanding array of financial products that are emerging. However, community banks must be attuned, perhaps better than many are today, to the full costs and revenues of each of the products offered. Community banks can and probably should concentrate on the quality of service because that area is one of the strongest existing comparative advantages, and quality service usually can command a premium price. Remember, though, that profits are the difference between revenue and costs. No bank's profit margins will be able to remain high for long in today's competitive environment if its management merely offers high-quality service while neglecting to pay close attention to costs. Banks that do, whether large or small, will soon find competitors with lower price structures and purportedly comparable levels of service attempting to erode their markets.

The third element of community banks' strategy must be to concentrate on a market niche, building on their existing customer base. Because you are already "close to the customer"—an attribute found to be critical in sustaining success in all businesses, you can help your clients make greater use of automation in payments and to accept new changes such as check truncation. You have the advantage that a large company must constantly struggle to attain and retain, that of being sensitive to your clients. I cannot imagine a community bank making the sort of mistake that led Citicorp to set up, for the sake of efficiency, separate lines and levels of facilities, ranging from full-service tellers to ATMs, that depended on the size of an individual customer's deposits. Although this program was quickly abandoned, to me it symbolizes the tendency of large bureaucracies, including those in banks, to seek efficiency sometimes at the expense of the very customer relations that comprise the essence of profitable business. If community banks can simply maintain their good record on this score, they will have a leg up on their much larger rivals.

What else do community banks and other small institutions need to do? I believe the last key is people. I would advise you to attract and hold executives who will adopt and implement technology successfully, who understand and can manage costs, and who have merchandising and people management skills. In saying this, I'm suggesting that you need to build staffs with mixed and balanced talents. You need aggressive marketing people with a sound knowledge of the latest financial instruments and services. You must have those with technical leanings and an appreciation for the importance of technological innovation. You also need service-oriented people working as tellers and in other areas where your bank is in direct communication with the customer. One reason community banks are more profitable is that your customers want an added degree of service—a smile, a remembered name, that extra effort that means so

much—and they're willing to pay a premium for such service. If you're to retain that important part of your customer base, you need to take care in recruiting, training, and supporting your front-office staff. However, these retailing, technical, and marketing personnel skills are not sufficient to guarantee continuing profitability for your institutions. You still need to have people with the skills and determination to use that sharpened pencil I mentioned a moment ago and whatever other tools are required to carry out incisive financial analysis of your products and your operations. By neglecting this type of skill, you run the risk of rendering the work of other personnel futile.

### **Conclusion**

Let me conclude by reminding you how exciting it is to be part of today's financial services industry, with all its changes and challenges. Despite the sometimes intimidating nature of these developments, community bankers appear to be in a good position to capitalize on the opportunities that continue to develop as the financial services industry becomes less regulated, more diversified, and more dynamic. In moving to take advantage of those opportunities, I am sure, you will provide better financial services to the public.