

**FINANCIAL SERVICES INDUSTRY RESTRUCTURING:  
THE CHALLENGE FOR COMMUNITY BANKERS**

**Remarks by Robert P. Forrestal, President  
Federal Reserve Bank of Atlanta  
For the Community Bankers Association of Georgia  
Lake Buena Vista, Florida  
September 17, 1991**

Good morning! I am pleased and honored to speak to the Community Bankers Association of Georgia, particularly now as Congress once again takes up the debate about banking reform. I have been asked to talk about the restructuring of the financial services industry and how community bankers should position themselves to survive the next 10 years. As many of you know, I have definite opinions about banking reform, and, frankly, some of these views may not comfort you, and you may disagree with them. Nonetheless, I presume that you did not invite me here to give you naive assurances that you have nothing to worry about or that the banking industry will remain the same. In fact, more than likely, the future will bring two changes many community bankers object to the most--nationwide interstate branching and consolidation. By candidly discussing these and other challenges facing your business, in my opinion, you will find ways to emerge stronger in the year 2000 than you are today.

**Brief Review of Bank Reforms**

Before I turn to a discussion of these issues and how community banks can best position themselves for the future, let me address the key elements of banking reform that I hope to see enacted. Understanding these changes--and the reasons they are needed--is vital because reform legislation could alter the basic structure of the banking industry.

As I see it, the most basic reform ought to be directed toward deposit insurance. Although deposit insurance has helped to shield the industry from systemic bank runs and has provided security for small depositors, it has also contributed to what is perhaps the industry's most critical problem, namely, overcapacity. Deposit insurance has served as an implicit subsidy, making it attractive to open a bank in an already crowded banking system. As a result, we now have too many banking institutions vying for too few sound loan prospects, reducing profitability to unsustainably low levels. Ultimately, this situation could pose a risk to taxpayers as well.

To some extent, the marketplace has begun to solve the problem of overcapacity through consolidation. Indeed, recently, some of the larger banks in the nation have begun to merge to strengthen their balance sheets. As we proceed through the 1990s, more community and regional banks may find themselves in similar situations. However, the public sector must play a role in the solution to overcapacity, because it has inadvertently contributed to the problem--both through regulation that created protected markets and by deposit insurance. While I believe it is socially desirable to keep deposit insurance, it is equally important, in my opinion, to reduce the deposit insurance subsidy. The kind of risk-based deposit insurance premiums that the Treasury Department has recommended is one way of doing this.

However, I believe that over time we also will probably need increased capital levels--higher yet than those agreed to among international regulators. This change would not affect your banks to the same degree as it would affect others because, in general, community banks

are among the best capitalized in the United States. The reason to increase capital levels for all banks is to make it less likely that any of them will have to draw on the insurance fund, in part because of the greater cushion each institution would have. Moreover, higher capital ratios would place more responsibility for oversight on equity holders. I do not expect market discipline to carry the entire responsibility for financial system safety and soundness, of course. When banks begin to get into trouble, prompt resolution is essential. More specifically, regulators must be authorized to require institutions to take immediate steps, including liquidation when necessary, when capital ratios fall below established thresholds. These two reforms could even lessen the need to apply the "too-big-to-fail" doctrine, which certainly has never benefitted a community bank.

After bolstering banks' capital and reducing the deposit insurance subsidy, I believe Congress should allow a general expansion of bank powers. In particular, sound banking institutions should be allowed to get into the securities, mutual funds, and insurance businesses.

Finally, I believe we must proceed to nationwide interstate banking, which we have in everything but name now. The patchwork of regional agreements among states has added to the expense of establishing new offices. The bank holding company structure requires redundant layers of management as well as boards of directors. If banking institutions could simply convert their subsidiaries into branches, they could move to consolidate their corporate and operational structures. This approach would be a relatively quick way to reduce some of the overcapacity that plagues the industry and thereby enhance banking profitability.

### **Effect of These Reforms on Community Banks**

Clearly, these reforms are meant to improve the safety and soundness of the financial system as a whole. This, of course, is the broad focus of my perspective as a central banker. Because community banks are relatively small players in the banking industry in terms of assets, you may feel beleaguered by the various ideas put forth to increase market competition and discipline within the industry--most of which seem to benefit only larger banks. But just as the race is not always to the swift, neither is the battle to the strongest or largest. I know that many of you are worried that liberalized interstate and product regulations would mean more competition in your local markets. Frankly, though, I believe that most community banks, especially those outside of metropolitan areas, have already experienced whatever major changes interstate banking might be expected to bring. Superregionals from outside the Southeast and the money center banks do not appear to be overly enthusiastic about acquiring smaller Georgia banks. Moreover, even if they wanted to come in, it is not clear that additional out-of-state organizations would be any more daunting as competitors than the major statewide Georgia firms.

Also, as I mentioned before, except for the smallest institutions, community banks are among the best capitalized in the nation today. Thus, they will not have to experience some of the profound balance-sheet adjustments the recent approach to industry restructuring would necessitate for many of their potential interstate rivals. As for new products, not all of the new powers will benefit large banks exclusively. I envision the small bank of the future as being able to provide its long-time local market with new services like insurance, real estate, and stock

brokerage. Such a full-service provider would be better able to withstand outside competitors.

In addition to these reassurances that you can compete in a reformed industry, let me also emphasize that, as a regulator and a policymaker, I care about community banks. That is because they are a vital element in the success of the U.S. economy. Community banks are generally the first place that small business owners turn to for a source of funds. You have also played vital roles in community projects, and, of course, you perform a key function in regard to household credit. The loans you make in your localities support some of the most basic functions that keep our economy active and strong. Because of this, it is important that community banks remain a healthy part of the U.S. financial system.

For these reasons, I am concerned that for the past three years, more than half of the banks that failed in the United States had assets of less than \$50 million. Besides these outright small bank failures, consolidation also took its toll on the community banking segment of the industry. Since 1980, the number of U.S. banking institutions with less than \$100 million in assets has decreased by more than one-quarter while their percentage share of total assets has been cut almost in half. Meanwhile, at the other end of the spectrum, the number of the biggest U.S. banks, with total assets of \$5 billion or more, has nearly doubled, while their share of total assets has increased by about one-third. Many of these small bank failures and much of this consolidation were due to overcapacity, as I mentioned earlier, and were therefore inevitable. But those of you who survived this first cut are now confronting a more severe test--competing in a financial world that is becoming more national and even global in scope.

You can no longer assume that people in your community will come to you first for services. For example, community bankers used to have the distinct advantage of seeing every real estate development deal in town come across their desks. Now that is no longer true because some savvy business people are bypassing their local banks and going straight to investment bankers and other financial intermediaries to meet their credit needs. With this loss of what we might call "first refusal," community bankers must work harder for the same amount of business. Although this does not mean the end of community banking as we know it, it is, I think, symptomatic of your current troubles.

As I see it, you face three main problems. First, small and mid-sized community banks are losing market share. Statistically, Georgia's community banks of \$50 million in assets or less have been declining precipitously since 1980. There are three-fifths as many of these banks, and their percentage of total assets statewide is down from almost one-third to less than 10 percent. (On a happier note, those Georgia banks with assets between \$50 million and \$100 million show only a slight decline in the percentage of total state assets, which is still about 10 percent.)

A second problem is that small banks are becoming less profitable. The net interest margin for U.S. banks with assets between \$25 million and \$100 million has declined by about 15 percent since 1980. To put this in perspective, however, the profitability of big U.S. banks has also been decreasing, and they are, in fact, less profitable than smaller banks.



Third, community banks face increasing competition from other banks and from technology. The competition does not necessarily come from the economies of scale we hear so much about, because studies have shown that these apply mainly to banks below the size of \$100 million in assets. However, larger banks can and do offer a greater range of sophisticated products like derivative instruments. These sometimes exotic transactions are becoming increasingly important to smaller businesses, which are trying to expand into global markets and need more than just money. Technology has also proved to be an important combatant in the field of banking. Now your local cost-conscious customers can easily sign up for bank cards from institutions across the nation that may have lower fees or interest rates than your banks do.

### **Strategy for Survival**

In the face of these three problems, community bankers are rightly asking themselves what strategy they should adopt. The big-picture reforms do not speak to your problems directly, and there is not much that policymakers can do that will solve the problems of particular segments of the banking industry. As I see it, you need to look largely to yourselves for answers. In doing so, you should continue essentially what you have always done but in innovative and creative ways.

I believe you should make more of your traditional advantage in information, for example. You say you know your customers, but I can tell you that I have been hearing for years--not just during this past business downturn--from small business leaders who complain

vehemently that they cannot get a loan from their local bank. One way to achieve more attentiveness to your credit customers is through your branch managers. Too often, as in other businesses, bankers are more interested in giving people what management thinks they want rather than giving customers what they really do want. To better gauge what their customers want, some community banks use branch managers to do customer sampling. They are closer to the front lines than most bank executives. The community bankers who have given their branch managers more of a stake in the business, treating them almost like franchisees, have been pleasantly surprised with their ability to open new accounts.

On the deposit side, many community banks could probably improve their delivery services. Community banks are retail institutions, and what retailers in this day and age are not open on weekends? With more and more two-income households, retailers everywhere have also learned they must stay open later at night to attract people who cannot shop until after work. ATMs have helped in this regard by extending hours around the clock, but often there are not enough of them--or their offerings are too limited--to be truly convenient to your busier and younger customers. West Coast banks have tended to be more creative in providing transactional convenience to their customers and in enticing them to use lower-cost services. One bank has recently started offering a checking account that carries no fees, provided the customer makes transactions through ATMs rather than through the bank's tellers. Supermarket branching is another area that provides convenient services to customers who must shop at least once a week, and usually more often than that. Customer convenience is the wave of the future in banking.



Another area that bears new consideration is the Community Reinvestment Act. As you know, the definition of a community bank is a locally owned bank that takes in local money and lends it back to the community. I cannot think of a better way to be true to this aim than to use CRA to your advantage. Because community banks have a traditional interest in their communities, they should be well positioned to work in partnership with community groups to respond creatively to this legislation. There are excellent examples--in Florida, North Carolina and in Washington, D.C., to name a few that have come to my attention. In the capital, the community has been very active and some banks, working in conjunction with the D.C. government, have created a lending pool for affordable housing, and one that, bankers tell me is also profitable.

Finally, it is becoming more important to scale back rather than to add on to your business. Since community banks have traditionally been known as generalists, this move toward specialization may seem to be a contradiction. But by scaling back on your wholesale business, for instance, in favor of your retailing, you should be better able to focus your resources. Some of the most successful community banks in the nation have realized that they can no longer be all things to all customers, so they have given up part of their business. In doing so, these banks have also become more profitable.

## **Conclusion**

To sum up, in this new atmosphere of banking reform, you cannot afford to be complacent about how you have succeeded in the past. Now is the time to do what you do better

and to build on your traditional strengths, which cannot be matched by money center banks or superregionals. The health of your banks is important to the overall health of our financial system, and through your efforts with small businesses, you help to make for a stronger economy. If you are to succeed in this more competitive banking industry, you must be bold and cautious at the same time. The very astute businessman who created the vast DisneyWorld complex nearby used to say that his roadmarks to success were what he called the 4 Cs: curiosity, confidence, courage, and consistency. I think these can also be applied to the new challenges facing you as community bankers. You must be curious about your customers to know them better; you must be confident that you will survive consolidation; you must be courageous enough to drop some lines of business to concentrate on a few; and you must consistently do what you do best. If you stay true to your community, it in turn will have confidence in you, and you will be able to survive the challenges of this decade.