

Remarks by Cathy E. Minehan  
before  
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I want to thank Jerry Little for inviting me to speak to you today as part of this very important and worthwhile program. Today's agenda really zeroes in on some of the key issues unfolding before the banking system nationally and here in New Hampshire.

As some of you are aware, I bring a somewhat different background to my current position than my immediate predecessors at the Federal Reserve Bank of Boston. I have spent most of my career on the operations side of the Fed dealing with the payments system. In that role, I spent lots of time working with bankers and market participants like yourselves both in solving crises and in developing operational approaches and

products that served the needs of payments system participants. I've found that's a useful approach to my new job as well. That is, I've been spending a lot of time with the data, and with the Bank's fine economists, but also considerable time talking to as many bankers, business people and community groups as I can about economic conditions in the District. So I appreciate this opportunity to come up to New Hampshire and I am looking forward to some discussion.

I would like to start by adding a few thoughts from my perspective at the Boston Fed to those you have already heard today on interstate banking. Then I would like to spend a few minutes on plans we have at the Boston Fed on the payments side and then on the new CRA regulations before we turn to your questions and comments.

The Federal Reserve System has long supported the concept of interstate banking, mainly because geographic diversification of risk will bring greater stability to the banking system. In times of duress, this should improve the flow of credit to local economies. Banks subject to artificial geographic restrictions have no alternative but to limit their credit exposure to protect their own viability. On the other hand, banks able to cushion losses in one region with earnings in another are better able to contribute to the recovery of their local economy. We've seen the effects of lack of diversification in the credit crunch that followed the decline of the New England real estate market, particularly in New Hampshire, as well as similar effects resulting from agricultural trends in the midwest, oil price changes in the southwest and high tech trends in California. Thus, to me interstate expansion of bank franchises has long seemed a necessary step forward in smoothing the regional impact of cyclical economic trends.

In light of the recent history, the passage of the Interstate Banking Act does not suggest immediate, sweeping changes in the New Hampshire banking environment. As you all know, interstate banking via bank holding companies has been a reality in New Hampshire since 1987, with both *de novo* entry and the acquisition of existing banks permitted by institutions based in states having reciprocal laws. Therefore, when the first phase of interstate banking becomes effective next year (acquisition by holding company), we are likely to find that those institutions seeking to acquire a bank in New Hampshire, as well as New Hampshire companies seeking to expand into neighboring states, have already had the opportunity to do so. The states that had been constrained by regional compacts are located primarily in geographically distant parts of the country, and would be unlikely to seek direct expansion into a market so far removed from their spheres of experience. Expansion into New Hampshire by companies located closer to home will be determined by their

growth objectives. Those franchises that have devised community-based strategies are the most likely to pursue expansion into the state.

At a later date, indirect entry into the area by virtue of the affiliation of one or more of the District superregionals with an out-of-District institution is a possibility. I should note that while some of our largest banks could be acquirers of institutions outside the region, no New England-based banking organization is so large that it is not a potential acquisition target or a candidate for a merger of equals. The existing market capitalization of \$2 to \$5.5 billion for the largest of our regional institutions is not adequate to insulate them from potential acquisition by far larger banking companies in other parts of the country or by foreign banks. Entry of an out-of District institution could lead to subsequent spin-offs of pieces of the extended franchise as acquirers restructure their holdings.

In any event, the most likely scenario in the near term would appear to be a continuation of the pattern of banking consolidation witnessed in recent years. At the risk of singling out a particular organization, which I generally avoid, the former First NH Banks, Inc. in Manchester, now Bank of Ireland First Holdings, Inc., provides a useful illustration of this trend. At year-end 1986, it was an independent bank holding company with 12 banking subsidiaries; today, all its subsidiaries have been merged into its lead bank. First NH Bank has expanded by merger with other in-state banks, and the holding company has been acquired by Bank of Ireland. Overall, since 1986 consolidation has cut in half the number of independent holding companies, reduced the number of commercial banks by 60 percent, produced a decline in savings banks of about one-third, and placed more than half of New Hampshire banking assets in out of state hands. Bank failures account for some of this consolidation, but a lot is also due to

banks building their competitive capabilities or positioning themselves for acquisition under favorable terms.

This process of consolidation seems far from over. New Hampshire, as well as other New England states, continues to be overbanked compared to the rest of the country. Population per banking office in New Hampshire has increased about 15 percent from 1986 to 1993, but New Hampshire density is below that for the First Federal Reserve District as a whole. And when compared to the U.S, density is about 25 percent below the national figures.

The next phase of interstate banking, involving interstate bank mergers (as opposed to holding company acquisitions), will commence June 1, 1997, unless states specifically elect to "opt out" prior to that date. Conversely, *de novo* branching across state lines will require that states enact legislation to expressly

"opt in." It is possible that many states may elect to "opt in" to interstate branching, either by merger or *de novo*, well before 1997. Some institutions having banking subsidiaries operating in more than one state are likely to press for the ability to consolidate those operations into a single bank due to pressure on earnings. Community banks whose markets straddle state borders may also push for early implementation of interstate branching to serve their customer base more effectively. The New Hampshire portion of the Boston market and the Maine portion of the Portsmouth-Dover-Rochester market are examples of areas where *de novo* branching across state lines in either direction would undoubtedly provide better access to customers. New England states seem likely to elect to be among the first to "opt in" because in many cases banking markets extend beyond state borders. Thus, in-state banks may benefit from early state action, and clearly have the political power to put this on state legislative agendas. Finally, New England has a history of being the first region of the country

to embrace new banking concepts, and I expect that trend will continue.

As legal barriers fall, we should note that *de facto* many banking services have been provided interstate for years. Banks have maintained loan production offices, have issued credit cards nationally and have solicited deposits throughout the country prior to the passage of the IBA. What Congress has accomplished in the IBA is to recognize economic reality and to remove artificial barriers that have constrained the provision of services to the public.

That's not to say it is without risk, however. Two closely related concerns have been voiced by opponents of interstate banking and branching. One is that small businesses would lose access to credit when faced with large impersonal organizations with centralized decision making and lack of knowledge of local

conditions. The other is the viability of small banks when they are forced to compete with large multistate institutions. But it is precisely because small businesses need community banks that these banks will continue to prosper. Well managed community banks have lending officers who have roots in the community, knowledge of local conditions, flexibility, and the authority to make lending decisions locally. All this makes community banks an indispensable source of credit for small businesses and assures their survival alongside large multistate institutions. In fact, data suggests that small well capitalized New England community banks have been fully capable of competing even during recent hard times. In 1991, when 14 New Hampshire banks failed, all but 3 of the 25 banks that booked a profit that year were under \$300 million in assets. Moreover, 13 of the 17 New Hampshire banks that have shown positive asset growth from 1990 to date are also under \$300 million.

The challenge for both large multi-state organizations and for community banks is to craft a business plan consistent with the strengths of their organizations in the environment(s) in which they will operate. This is likely to be a moving target, however, since change seems a permanent fixture on the regulatory landscape. The Interstate Banking Act itself calls for an independent study of the financial services industry and an assessment of existing laws and regulations that could stimulate further reform at the national level. The report, due to Congress by year-end 1995, must include recommendations to improve the operation of the financial services system, protect consumers, and promote competition, economic growth and efficiency while controlling systemic risk and exposure to taxpayers. Meanwhile, states should review their banking laws in light of the IBA, especially tax implications and deposit caps as well as consumer oriented legislation. A challenge for all banking organizations large and small will be to track closely those

proposals that affect their business strategies so that they can influence the outcome and be prepared to respond.

Among the threads running through the topics that have been addressed by other speakers today are the opportunities that have been made possible through the evolution of technology. Before the advent of sophisticated decentralized computer systems, and high speed telecommunications processes, interstate banking was cumbersome and expensive; a notion of limited appeal to the public and to the banking industry. Similarly, the development of complex investment products such as derivatives, and the management of those products, could not have occurred in the absence of sophisticated modeling techniques and systems to monitor, manage and control the associated risks. In the payments arena, the past decade and a half have witnessed a veritable explosion of transfer volume and geometric increases in value, again made possible by advances in technology in the

banking industry. I'm sure all of you have spent some time pondering technology plans, and developing new products for the future.

In doing our own planning, we at the Boston Reserve Bank believe we should provide leadership in New England in the development of innovative high-quality and high tech payment services to meet the needs of our customers and to provide savings in operating costs - both theirs and ours. One way we've seen to do this is to provide educational outreach related to our electronic automated clearing house (ACH) services through collaborative efforts with industry associations and local depository institutions. Another way has been the introduction of products this year and next that focus on a more electronic flow of check information, and on digitized image capture and transmission. Nationwide, we've also been active in designing a successor to our Fedline terminal, and some of you may have participated in the

concept engineering that went into this project. You also may have seen a recent press announcement indicating our Bank now has System-wide responsibility for planning and implementing check and ACH services nationally. In taking on this large task, we see our role as one that tries to enlarge the cooperation among banks and the Federal Reserve System that is needed to make important improvements in the payment system. That is our obligation as the country's central bank, and we hope to better balance that innovative role with the provision of competitively-priced payments services.

This brings me to the new Community Reinvestment Act regulations.

We are convinced, as are many bankers, that safe and sound lending that meets the needs of low-and moderate-income communities is not only of special value to the economics of

neighborhoods and cities, and rural communities, but can also be profitable, sensible banking. We at the Boston Federal Reserve Bank have been urging banks for some years to meet their responsibilities in this area by using the same sort of strategic business planning for lending in low-income markets that they use in other lines of business.

Under the federal agencies' policy guidelines, banks are encouraged to treat credit needs of low- and moderate-income members of their communities as they would any other market they choose to serve but they are required to document this effort in detail, and in part are graded on their documentation of the process.

Many banking institutions, especially smaller ones, found the documentation requirements burdensome. Both they and many community representatives claimed that the regulations did not put

sufficient weight on what the banks were actually doing to meet the credit needs of their communities. Accordingly, federal Examining Agencies were directed to devise a new set of regulations that would reduce the documentation and place more emphasis on verifiable accomplishments. This has proved no easy task. The first attempt drew thousands of comment letters; the second version is currently out for comment.

- no grace period
- menu - streamlined under 250
- strategy plan

For institutions with less than \$250 million in assets, the proposed regulations are clearly less burdensome. Smaller institutions will be judged on their loan-to-deposit ratios, proportion of lending within their own service areas, lending to borrowers of various income levels and business borrowers of various sizes, and their response to written complaints. They will be exempt from new data collection requirements and from the need to document in detail all their outreach efforts.

Larger institutions are judged on their results in three broad areas--lending, investment and services, with the emphasis on lending. One new and controversial element of the new regulations is a requirement that data be reported on small business loans, according to race, gender and geographic location.

Once the new regulations have been issued, turning them into examination procedures will take a great deal of careful work. The examining agencies have a new implicit responsibility -- determining the "context" within which individual examined banks operate. The extent to which a bank's efforts have actually met credit needs is at least one question that must be addressed, and may not always be easy to answer. Training examiners to fulfill that responsibility will be addressed in part through our New England Council of Consumer Examiners, where all the examining agencies work toward consistency and quality in examination procedures.

I should also note that the new CRA regulations continue to be the focus of considerable debate--bankers of all size dislike them for various reasons, and community groups are dissatisfied both with the regs and with the Federal Reserve as well.

Moreover, these new regs continue the primary problem inherent in CRA--they impose a large regulatory burden onto only one industry--banking--while other non-bank providers of credit are not subject to similar reporting and examination requirements. I certainly support the intent of CRA, but I worry about its impact.

Community economic development is indeed a complex subject. Community development lending often requires collaboration among banks, and between banks and public agencies, to generate loans that meet the test of safety and soundness. Last week, I met with officers of The Development Fund who I understand are working with many of you to form the New Hampshire Community Reinvestment Corporation. You may

or may not be aware that this CRC is only the latest endeavor of The Development Fund, which first formed the California CRC in partnership with the Federal Reserve Bank of San Francisco. I'm proud that we in the Fed have helped this innovative type of bank consortium to be successful, and I plan to be here in New Hampshire in February as yours is launched.

One other step the Federal Reserve Bank of Boston has taken to be of assistance involves our Community Development Finance course, which we host several times a year in locations around New England, including New Hampshire this September, to acquaint banks with the principals of community lending and some of the programs that make it more viable. Some of you may have participated in our seminars to inform senior bank officers and directors about the requirements of the Community Reinvestment Act.

The implementation of the new CRA regulations will no doubt be a complex undertaking, yet I believe the process and the outcomes will be much better if we can all work together. I would ask that you bring to us at the Fed and other regulatory agencies, perhaps through your Bankers' Association, the issues that you feel need to be considered, as they arise. We hope to maintain the dialogue with the banking community around the encouragement of safe and sound lending in needy areas -- dialogue that has been constructive and fruitful in the past.

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