MICHIGAN COMMUNITY BANKERS ASSOCIATION

Traverse City,
September 16, 1999

I. Intro

A. Thank you for inviting me to take part in your annual conference.

*[**Optional joke:** And thank you for choosing my talk over the wine tasting next door. I've been hearing a lot of good things about Michigan's blueberry and cherry specialty wines. In our industry we have our own specialty whine: we hear it from people whenever we raise interest rates.]*

1. I'm particularly pleased to be here on the 25th anniversary of the Michigan Association of Community Bankers.

2. As you mark your 25th anniversary of service, it's an appropriate time to ask the question: What does the future hold for the banking industry?

B. We're seeing a lot of changes these days, especially in terms of technology. I, for one, sometimes feel as if the Chinese curse "may you live in interesting times" has been cast on us.

1. It's not always comfortable to look into the future of your industry and see lots of activity and competition, but at the same time not very many indicators of how it's all going to turn out. It used to be different.

2. You could say that banking in the past was like the round of golf many of you will be playing later today: you know the order of the holes ahead of you. The challenge is to avoid the sand traps and keep ahead of the competition.

3. But the next phase in banking is going to be even more complex: the layout of the course will be less clear as technology paves the way for more and more competitors to enter the financial services industry.

C. Recently, I read in the Wall Street Journal about Yahoo setting up a Web bill payment service to compete with similar ventures owned by banks. It's amazing really.

1. What would you have thought if I had stood up here five years ago and said that banks would be facing competition today from a complete novice to the financial services industry that had just been founded by two California grad students studying computer science.

2. And further that the name of this new organization would be (pause) Yahoo?

3. I suspect you would have gotten up right then and headed for the wine-tasting next door…….and assumed I had already been there.

D. This just shows how dangerous it is to try to accurately predict the future. That's why economists always say, when giving an economic forecast that you should give a number or a date, but never both.

E. Today I'm going to give your neither. What I will do here today is lay out how these years of transformation will affect the Fed's interaction with the banking industry.

II. Y2K

A. To begin, let's look at what's in store for the banking industry in the immediate future, in terms of Y2K.

B. First of all, I'd like to reassure you that there is no truth to the rumor that the Fed is stockpiling slide rules, sundials, and adding machines. In fact, we're confident that the century date change will come and go with a minimum of disruption.

C. We believe that the public will keep the year 2000 rollover in perspective, realizing it is one more challenge we will meet.

1. Certainly, community banks must be given credit for the work they've done informing their customers of the soundness of their banks and readiness for Y2K.

2. Banks that have had the greatest success with informing customers have gone beyond the statement stuffer.

3. In fact, a recent Gallup poll indicates that the more information customers have about Y2K preparedness, the more optimistic they are.

D. At the Fed, we are addressing Y2K at all levels. As I'm sure you know, we have three main areas of responsibility.

   1. First, we are a service provider: we provide financial services to banks and the U.S. government.

   2. Second, in the role many of you know well, we are a bank regulator: we supervise state member banks and bank holding companies, and branches of foreign banks.

   3. Finally, but certainly not of least importance, we formulate national monetary policy. We're committed to doing all we can to safeguard the operations of the U.S. financial system. That's the reason Y2K preparedness has been so important to the Federal Reserve System.

E. Internally, we've already made significant progress in preparing for the rollover. All of our most important systems are ready for Y2K and are already in production.

   1. As a financial service provider, we're confident there will be no disruption in our ability to meet the needs of you our customers, the commercial banks, nor the needs of the U.S. government.

   2. As a regulator, we're working closely with other regulators to review the preparedness of all the commercial banks we supervise.

   3. Ultimately, it's up to you to be sure that you're ready. But the results of our Y2K exams so far indicate that 99% of banks are making satisfactory progress.

F. There is an old saying that a person surprised is already half-beaten. We have certainly taken this to heart, and we have no intention of being surprised by anything Y2K has to offer. But sound preparation is only part of the battle.

   1. There is still some concern that popular misconceptions about Y2K that could lead some people to withdraw unusually large sums of money from their bank accounts.

   2. For this reason the Federal Reserve is making available to you more than enough cash to cover any unusually large demands by customers.

G. Some are also concerned that credit lines may be drawn down as we approach year-end.

   1. As always, the Fed stands ready to provide liquidity through the discount window.

   2. In addition, we have introduced a new liquidity facility to meet Y2K-related needs.

   3. You should make sure that you have made all the necessary arrangements ahead of time in case you need to access these facilities.

III. Technology and the Economy

A. Now, let's look at the bigger picture. There is no doubt that the rapid technological transformation of business and banking is impacting, and being impacted by, the vibrant economy we are currently experiencing.

1. Over the past few years of the current economic expansion we've seen a rare combination of robust growth, and both low inflation and low unemployment.

2. Growth has been driven by unusually strong consumer spending, and our expectations for growth in 1999 are even more positive than earlier this year.

B. It was only last fall that many were concerned that the prospects for sustained growth were threatened by a significant seizing-up of U.S. financial markets.

1. The FOMC responded to those developments by decreasing its target for the federal funds rate from 5? percent to 4? percent.

2. Since then, we've seen a significant easing of financial strains and continued tight labor markets in the U.S., and the outlook for foreign economies has improved.

3. With the U.S. economy growing at a healthy pace, the FOMC decided the degree of easing required to address the global turmoil of last fall was no longer consistent with sustained, non-inflationary growth.

4. Therefore, the Committee twice increased its federal funds rate target by a quarter of a percentage point to the current level of 5¼ percent.

5. In a related move, the Board of Governors approved a quarter of percentage point increase in the discount rate to 4¾ percent.

C. The strength of the U.S. economy over recent years is evident by looking at the Midwest.

1. Most of our manufacturing industries, which in earlier days earned us the "Rustbelt" moniker, are running near capacity.

2. The automobile industry, which, as you know, is heavily concentrated in this state, reported sales results for the past three months that were the strongest since 1986.

3. Sales of both new and existing homes in the Midwest have exceeded practically everyone's expectations, which in turn has kept items such as appliances, electronics, and lawn furniture, selling rapidly.

4. At the same time, strong employment growth earlier in the 1990s pushed unemployment rates in the region much lower than the nation as a whole, where they remain today.

D. Michigan's economy is particularly strong.

1. Your July unemployment rate was 3.4%, well below the national average. In fact, this is the best job market Michigan has seen since 1970. Unemployment has been below the national average for over two years straight.

2. Much of Michigan's impressive performance is due, of course, to booming vehicle sales. And strong household balance sheets indicate that consumers remain in the mood to buy cars and trucks.

3. Auto sector success is spilling over to other industries as well.

   - For example, in Southeast Michigan, hotel room revenues are rising faster than in any other top hotel market in the country.

4. The only major downside of the Michigan economy is the shortage of workers that businesses say are holding back expansion plans.

E. Some of your neighboring states are also facing problems in the agricultural sector, which is struggling because of low commodity prices.

   1. But, as compared to the '80s, even those states are doing well overall.

   2. Since the Midwest's industrial sector is faring so well, it is serving as something of a buffer for those states with a large agricultural sector.

F. As I mentioned earlier, in addition to its monetary policy role, the Fed is a service provider for the banking industry, and is responsible for the safety and soundness of the banking industry. And just as your role in the financial industry is changing, so is ours.

IV. Future of Community Banking

A. So what will the financial community of the future look like? You may have heard that community banks are in decline and unable to compete with the big banks as they get larger and leaner.

B. But we at the Federal Reserve Bank of Chicago think the picture is far more complex. In fact, we think the reported demise of smaller banks is greatly exaggerated, paraphrase Mark Twain.

   1. Certainly, being bigger, in and of itself, does offer some potential efficiencies. And certainly there will be continuing consolidation among community banks. But community banks do have some key advantages.

   2. For example, small banks can offer individual attention and faster decision making at the local level. And there are many consumers who associate larger banks with bureaucracy and stringent policies.

   3. Furthermore, we've all heard a lot in the media about privacy concerns. Some people are concerned enough about privacy to be turned off by the mere thought of one-stop shopping at a larger bank.

C. The successful banks of the future will be well-managed banks, whether they are small or large.

   1. Community banks will always be in demand for their ability to offer high-quality, face-to-face customer service.

   2. And now that technology is giving all banks affordable access to all products and services — even those once only available to customers of larger banks — customer service may become an even bigger point of sale.

   3. The number of start-up banks in recent years lends support to this position. In fact, Michigan had 24 new banks established over the past five years.

   4. Furthermore, Michigan is the only state in our district that has had an increase in the total number of banks over the past few years.

D. The mid-sized banks, may on the other hand, be in for hard times.

   1. We foresee a "barbell" shaped industry, with the majority of banks clustered at the two ends. At one end would be the larger banks, and on the other, the community banks.

   2. Mid-sized banks, in contrast, may struggle with a bit of an identity complex as they search for their niche in the market place.

V. Fed's role as service provider

A. The changing shape of the banking industry in recent years made this a natural time for the Fed to reconsider its role as a service provider. Perhaps that is putting it mildly. We explored all options.

   1. For example, we even analyzed the potential impact on your business if we privatized our check processing functions.

   2. In the end, however, it was clear that the majority of players in the banking industry wanted the Fed to remain an active participant in providing financial services.

   3. In particular, there was a strong desire among community bankers that the Fed continue to provide check services to ensure that there was sufficient competition in the area.

   4. Many of you did not want to be dependent on your competitors for such essential services.

B. But this does not mean the Fed's role as a service provider has not changed.

   1. Although we will continue to run the check clearing services on which many of you rely, that function may be less important to your business in the future.

   2. It is true that we continue to see the use of checks increase each year. But, for the first time in the several decades since electronic payments became more than just science fiction, we believe the tide is turning and electronic payments is close to reaching critical mass … the banking industry is spreading its wings.

C. Until now, electronic payments have been rather slow to take hold.

1. Take smart cards, for example. One would think people would be attracted to the idea of one card that combines your drivers' license, bank card, and credit card all onto one piece of plastic.

2. The technology has been around for some time. But people just haven't taken to them. None-the-less, smart cards shouldn't be written off yet.

3. They work well under certain circumstances. Many college campuses use them. And they work great on military bases, where soldiers and their families live in tight communities with similar activities and interests.

D. In short, we can't evaluate the success of electronic payments as we would evaluate other consumer goods.

1. Smart cards are not Beanie Babies. Nor would we want electronic payments to be here today and gone tomorrow.

2. It isn't a bad thing that consumer acceptance of electronic payments is an evolutionary process. As many of you will recall, the credit card took many decades to reach its current level of popularity.

3. Smart cards may require an equally lengthy gestation to reach a similar level of acceptance. Staying power is more important than being the flavor of the month.

E. The slow acceptance of automatic payments, such as ACH and home banking, has also concerned many in the industry. Some consumers don't trust ACH.

1. I can understand that a young family living paycheck to paycheck would be nervous about the perceived loss of control over the timing of payments coming out of their account.

2. And it's understandable that they'd have reservations about signing up for ACH until they are confident that all businesses that they deal with are willing to accept that form of payment.

3. At the same time, businesses don't want to invest in new equipment and marketing campaigns until they are confident there will be enough volume to make the investment cost effective.

4. This paradox is the main reason why electronic payments are lagging behind the internet in terms of market penetration.

5. The public's message is: Technology's great, just don't play around with my money.

F. That's why, the Fed has made public education about the advantages of electronic payments a top priority, and we are working hand in hand with NACHA in this area.

1. But education campaigns are not enough. Customers want electronic payments to be as user friendly as credit cards, 1-800 number and all.

2. And that kind of customer service is going to require further close and collaborative work among financial institutions, corporations, and technology providers.

3. The good news is that recent announcements from key financial industry services leaders suggest that this is, in fact, the trend.

G. More good news is that we may not need to wait for consumer acceptance to take hold. Business-to-business transactions, although only a small portion of all payments, may lead the way.

1. For instance, consider large industrial companies like General Electric who have automated their accounting and purchasing functions.

2. Some of these firms have now even gone into the business of facilitating electronic commerce, leveraging their internal successes.

3. Over the last decade, firms have moved customer transactions from the back-office to the front office, allowing easier and more standardized order entry and better tracking of service and delivery.

4. For instance, if I buy ten of the chairs you're sitting on at this very moment, the manufacturer is likely to make them only after I've placed the order, rather than pull them out of inventory.

5. Companies are less likely to operate their business based on speculations regarding future demand.

H. Again, this is all the product of a slow evolutionary process in which technology is slowly increasing our productivity and changing the way we do business.

1. It is critical to think about these developments over the longer term…decades rather than months.

2. With this understanding, it is hard not to be optimistic about developments in electronic payments.

VI. Fed's role as bank supervisor

A. Like electronic payments, the Fed's role in supervising the financial industry is evolving in response to the changing environment.

B. The Federal Reserve supervises nationally nearly 1,000 state member banks and 5,000 bank holding companies nationwide. And each and every one is a moving target.

1. Some of you, have no doubt, left your office one day to return to what is, in terms of risk, an essentially different bank the next.

2. Changes in the entire risk profile of your bank can occur in a matter of hours. Just by picking up a phone, you can sell loans, purchase deposits, or use derivatives to improve your ability to manage credit and interest risk.

3. And because service fees are a greater portion of bank income than in the past, the ebbs and flows of business are also of greater concern than in the past.

C. If I had to highlight what our bank supervisors do differently today, as compared to how we supervised financial institutions in the past, I'd say we are far more pro-active.

1. For the past 85 years the Fed has been a cop-on-the-beat of the banking industry. Now, we're more like risk analysts.

2. Our goal isn't to have to come in after the fact and clean up the problem. Rather, we want to foresee problems well before they come into fruition, in order to help banking institutions better manage risk in an increasingly complex age.

3. Fed supervisors today need to know competitive forces facing your bank as well as enforce banking laws.

4. And there is good reason. Focussing on risk management at the individual bank level is the best way to limit problems and contribute to macroeconomic stability.

D. This change in focus has also altered how our supervisors go about doing their jobs. I hope that you've seen the change.

1. At one time a supervisor would show up unexpectedly at a bank, badge on display like Kevin Costner in "The Untouchables."

2. Now you're more likely to find regulators on the phone, keeping in regular communication with bank managers.

3. And when on-site bank examinations do take place, they are no longer cookie-cutter events.

4. We tailor bank exams now to focus on the areas of greatest risk. In doing so, we've made the entire process more efficient, both in terms of resources spent by the Fed, and time dedicated by you and your managers.

E. We also coordinate exams and visitations and share information with other federal and local agencies, to avoid taking up more of your time than we have to. That's a far cry from the days of asking for everything in triplicate.

F. In fact, we're becoming more efficient bank supervisors in many ways.

- For example, because our supervisors visit many institutions and see many different approaches to similar problems, we can keep bank managers advised of the best practices we've seen, as well as provide alternative solutions.

G. As a matter of fact, a Chicago employee was recently singled out in the Fed system for outstanding achievement not for his work examining a particular bank, but for his ability to spread the word about best practices.

VII. Conclusion

A. In conclusion, I want to say that the banking industry and community banks in particular will continue to play an active and important role in the economy.

1. Certainly you are now operating in a changing environment in which not all banks will survive.

2. But community banks are not dinosaurs. The best will continue to thrive.

B. And the Chicago Fed is committed to working with you as we carry out our various responsibilities to help ensure a healthy, vital community banking sector for many years to come.