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Do Community Banks Have a Future?

Timothy J. Yeager

The United States is unique among industrial countries for the ubiquity of its community banks, loosely defined as those that have less than \$300 million in assets and are not owned by a large bank holding company. In fact, the United States has more community banks per capita than any other country in the world. Recent changes in our banking environment, however, threaten the long-term viability of these institutions. Rapid advances in technology have given financial services customers more options than ever before. At the same time, branching restrictions that once kept larger banks at bay have been eliminated, allowing head-to-head competition. While community banks continue to offer a valuable commodity—personalized service—the size of their market niche will depend on their ability to monitor overhead expenses, develop innovative products and services, and employ modern strategies for managing risk.

It's no secret that community banks' personal relationships with their customers are key to their success. Many depositors prefer human tellers to ATMs and value the relationships they develop with bank staff through repeated transactions. As a result, the bank can rely on a large, stable base of core funding that is relatively insensitive to market conditions. In terms of lending, community banks maintain an edge in originating small business loans, for which little public information about the creditworthiness of the borrower is available. Intangible information, such as an entrepreneur's reputation in the community, is obtained more easily by a community banker. Likewise, because loan officers at small banks are closer in the chain of command to senior managers, they generally deal with less bureaucracy and, therefore, have more discretion in lending with "exceptions." They may also be more flexible in tailoring their loan policies to small business customers. These advantages help community banks remain competitive in a market in which substantial economies of scale and scope allow larger banks to offer more attractively priced options.

While personal service is undoubtedly a valued commodity, there is a trade-off between service and price. The convenience and affordability of large bank products tempt customers who put less value on personal service. Unless community banks find a way to compete, they will continue to lose market share to larger banks. In 1983, community banks held one-fourth (as measured by assets) of the banking industry's market share; by 1998, that share was just one-eighth.

To remain competitive, community banks must find a way to trim overhead costs. Small banks, especially those with assets less than \$100 million, have efficiency ratios several percentage points higher than those of larger banks. This is due, in part, to the relatively high personnel costs related to personalized service. One solution is to generate additional fee income by offering customers new products, such as trust, brokerage and financial planning services.

Community banks must also modify their approach to risk management. In the past, credit risk was a community banker's greatest concern. Today, these banks face a more complex array of risks. For example, many community banks have turned to Federal Home Loan Bank advances to offset the recent dearth of core deposits. These funds, while useful for managing net interest margins, potentially expose the bank to greater

levels of liquidity and market risk. Other community banks are tailoring mortgage loans to their customers' needs by reducing the amount of equity required to eliminate mortgage premium insurance. Such loans cannot be securitized, which may increase a bank's exposure to interest rate risk. To compete successfully with large banks without compromising safety and soundness, community banks will need to devote additional resources to measuring and monitoring these risk exposures.

The rules of the game are changing for community banks. Their role in the future banking environment depends upon their ability to innovate and simultaneously manage new types of risks.

Boyd D. Anderson and Thomas A. Pollmann provided research assistance. A longer version of this article was published in the October 1999 issue of the St. Louis Fed's *Regional Economist*.



Fed Commissions Economic Study of Memphis Zone

Like much of the United States, the Memphis region has benefited from a strong economy in the '90s. Its trade, transportation, gaming and health services industries have established the Memphis region as a vibrant business environment. According to a study commissioned by the St. Louis Fed, however, rural counties in the region continue to suffer from a lack of growth in population, jobs and income. David H. Ciscel, economics professor at the University of Memphis, was asked to develop a portrait of the economic changes that have occurred during the past two decades in the Memphis region's rural and urban counties. Ciscel analyzed data for counties in the St. Louis Fed's Memphis zone, which comprises 39 counties in northern Mississippi, 21 counties in western Tennessee and 13 counties in eastern Arkansas. In addition to the Memphis metropolitan area, the region contains three smaller, but important, urban market centers: Jackson, Tenn.; Jonesboro, Ark.; and Tupelo, Miss. Based on his findings, Ciscel concluded that the rural economies of the Memphis region lag behind both the national economy and the area's urban economies on every significant measure of economic well-being:

- Although the total rural population was greater than the total urban population in 1995, population growth was concentrated in the urban areas. Between 1975 and 1995, urban population growth was 20.3 percent, while rural growth was almost stagnant at 0.4 percent.
- 1990 educational attainment levels in the rural counties were lower than those in urban counties and significantly lower than levels in the United States as a whole.
- Job creation improved in all areas of the region; however, rural job creation was less robust. Between 1985 and 1995, the urban counties added 175,988 new jobs (up 31.7 percent), while rural counties added only 101,091 jobs (up 19.8 percent).
- While rural per capita personal income grew during this period, it grew more slowly than urban per capita income and remains at approximately two-thirds of the national level.
- Throughout the region, average yearly wages per job improved at a slightly faster rate than personal income. However, the rural wage level deficit is significant compared with the wage level of the Memphis MSA.

To fill these gaps, Ciscel recommends that local economic development initiatives focus on integrating the economies of the rural and urban areas. He also believes that those interested in promoting growth in the Memphis region must recognize that the economic structure of the rural counties is evolving from an economy based on agriculture and manufacturing to one based on trade and services.

The Fed's Community Affairs Department will use the study's findings to better direct its economic development initiatives in the Memphis region. It also plans to distribute Ciscel's report to a number of Memphis-area financial institutions and community organizations. The report will be available on the St. Louis Fed's web site at http://stlouisfed.org/community_development/assets/pdf/urban_sprawl.pdf.

Population and Jobs in the Mississippi Delta

	1985	1995	1985-95 Change
Population			
Rural	1,555,347	1,558,773	0.2%
Urban	1,158,677	1,297,899	12.0%
Jobs			
Rural	510,853	611,944	19.8%
Urban	554,380	730,368	31.7%

The views expressed by David Ciscel are not necessarily official opinions of the Federal Reserve System or the Federal Reserve Bank of St. Louis.



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<https://www.stlouisfed.org/publications/central-banker/winter-1999/fed-continues-to-enroll-new-eta-providers>

Fed Continues to Enroll New ETA Providers

Last spring, the Fed launched an aggressive campaign to inform financial institutions about the U.S. Treasury's Electronic Transfer Account (ETASM), a product designed to give individuals who receive federal payments electronically access to an account at a reasonable cost. More than 7,000 institutions requested enrollment kits. To date, 364 federally insured banks, savings and loans and credit unions have registered as ETA providers.

The Treasury and the Fed continue to promote public awareness and to recruit institutions as providers. By offering the ETA, an institution has an opportunity to expand its customer base to include individuals outside the financial services mainstream. Millions of federal benefit, wage, salary and retirement recipients are eligible. Institutions will also receive CRA consideration for offering this valuable community development service. The Treasury will provide free public relations kits and in-bank marketing materials to help financial institutions promote the ETA. It also plans to introduce a national voice response system in the first quarter of 2000 to assist ETA customers and help individuals locate ETA providers.

For more information, contact your Federal Reserve account representative, or call the toll-free customer service number, 1-888-382-3725.



CENTRAL BANKER | WINTER 1999

<https://www.stlouisfed.org/publications/central-banker/winter-1999/meeting-the-y2k-communications-challenge>

Feditorial: Meeting the Y2K Communications Challenge

Mary H. Karr

As in much of the banking industry, getting the word out on Y2K readiness has been a way of life at the Federal Reserve for the past year. During 1999, staff members and officials from throughout the Fed System have participated in hundreds of outreach activities, including public and industry forums, media events and congressional briefings. The continual progress in Y2K preparations, testing and contingency planning has enabled the financial industry and its regulators to report a steady stream of good news.

These communications efforts have paid off. A November report on a Gallup poll sponsored by the Fed and the FDIC indicates that nine out of 10 U.S. bank customers believe that their banks are ready for the Year 2000. Of those surveyed, nearly 70 percent report that they are receiving Y2K-related information from their financial institutions. Most important, the survey also reveals that only 39 percent of the respondents plan to withdraw extra cash prior to the New Year—down from 62 percent in March.

The Gallup results underscore the tremendous effort that the financial industry has made to communicate Y2K readiness. But while public confidence is moving in the right direction, the task is not quite finished. Fed Gov. Edward W. Kelley Jr. has said that we face two challenges related to the Y2K problem—preparing our technical systems and gaining public confidence. With 99.9 percent of all U.S. depository institutions deemed ready, it appears we have mastered the technical hurdle. The Gallup survey indicates we've turned the corner on public confidence as well. But public confidence can change quickly, especially if rumors and speculation go unchecked.

To combat Y2K misinformation, I encourage financial institutions to build upon the relationships they have established thus far and continue to talk to their customers. The Fed intends to maintain Y2K communications well into the New Year. Public Affairs staff at each Reserve Bank and at the Board of Governors will stand ready to provide information on the health of the payments system to the public and the press throughout the rollover weekend. While we do not expect to report on major problems New Year's weekend, we are prepared to accomplish what each of us has been working toward this past year—meeting the challenge of public confidence.



CENTRAL BANKER | WINTER 1999

<https://www.stlouisfed.org/publications/central-banker/winter-1999/financial-institutions-focus-on-customers-as-y2k-approaches>

Financial Institutions Focus on Customers as Y2K Approaches

As 1999 draws to a close, the banking industry is modifying its approach to Century Date Change preparations.

For the past two years, financial institutions have concentrated their efforts on testing information systems and preparing contingency plans, says Jeff Dale, the St. Louis Fed's Century Date Change coordinator. With their preparations complete, they are shifting their full attention to the needs and concerns of their customers.

Dale suggests that financial institutions take advantage of every possible opportunity to emphasize certain key messages:

- This institution is prepared. All critical systems have been tested, and a contingency plan is in place.
- There are a variety of payment resources available to consumers—cash, checks, credit cards, debit cards, ATMs, tellers.
- The federal government's protection of insured deposits will not be affected by Y2K.

Frontline staff should be comfortable with these messages and know where to refer customers when they don't have answers, says Dale. "Staff members can also help customers avoid Y2K-related fraud by reminding them to protect personal information, such as bank account, credit card and Social Security numbers."

This issue of *Central Banker* examines how communications can help maintain public confidence in the financial system throughout the century rollover. For additional information, call Jeff Dale at (314) 444-8400.



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<https://www.stlouisfed.org/publications/central-banker/winter-1999/regional-roundup>

Regional Roundup

Coupon Redemptions Shift to the Dallas Fed

Effective Jan. 1, 2000, redemption of U.S. Treasury detached, semiannual interest coupons will be consolidated at the Federal Reserve Bank of Dallas. All other Federal Reserve Banks and Branches will stop processing Treasury coupon redemptions at the close of business Dec. 31, 1999. After this date, all coupons should be sent to:

Federal Reserve Bank of Dallas
Coupon Processing
P.O. Box 660656
Dallas, TX 75266-0656

Coupons will be paid within one business day of receipt, but no earlier than the interest due date. The Dallas Fed will make payments to financial institutions by crediting the institution's reserve account. Individuals will be paid through a fiscal agency check.

Fed Offers Educational Seminars on TIP and PATAX

In early 2000, the Fed will conduct seminars to introduce institutions to the Treasury Investment Program (TIP) and Paper Tax System (PATAX), which will replace the current Treasury Tax and Loan (TT&L) program later next year. Cash managers and operations staff from all TT&L Note Option institutions will be invited to attend a one-day seminar discussing the applications' features, which include a new investment option, enhanced reporting and the ability to initiate account changes online. The seminar also will cover improvements in collateral monitoring, customer support and electronic access.

The St. Louis Fed will host seminars in the Eighth District during the week of Feb. 7 and in the Tenth District during the week of March 13. Look for additional information in the upcoming months.



FedFacts

Eighth District Offers New Float Pricing Option

The St. Louis Fed has begun offering a new check enhancement called Explicit Float Pricing. This option enables financial institutions to receive a single credit for the total dollar amount of each Mixed and Other Fed cash letter deposited. The daily float fee includes the aggregate float charge, reduced by 10 percent, and multiplied by the New York fed funds rate. This total is then divided by 360. Like other Fed services, fees may be offset with monthly earnings credits. While accounting statements will reflect a single credit, institutions will still be able to track deferred dollars. The Fed will continue to provide a mixed advice with a complete breakdown of cash letter deposits.

U.S. Treasury Unveils Designs for New Bills

On Nov. 15, the U.S. Treasury Department unveiled new designs for the \$10 and \$5 bills. Like the changes made to the higher denominations, the new designs incorporate security features intended to deter counterfeiting. The new series 1999 bills will not be issued until mid-2000. In the interim, the Treasury, Federal Reserve, Secret Service and Bureau of Engraving and Printing will launch a comprehensive public education effort to provide informational materials and training for bank tellers, retailers and other cash handlers. For more information, visit the Treasury's web site at www.bep.treas.gov.