Remarks
by
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before the
Annual Meeting
Conference of State Bank Supervisors
Nashville, Tennessee
May 2, 1998

Thank you, and good morning.

I have been told that, a number of years ago, the management of the Canadian National Railroad ordered its staff to find a way to decrease the number of train crashes. After exhaustive analysis and computer simulation, the staff found that, with large statistical significance, the car most involved in crashes was the last car of the train. With impeccable logic, the staff recommended that, to decrease the number of crashes, the management have crews remove the last car on all Canadian National trains.

To every problem there is an answer that is simple and elegant -- and wrong.

Announcements over the last few weeks have lead observers to a number of simple conclusions about the future of banking and financial services. Today, I'm here to suggest that the implications of what we are seeing might not be as clear as they might first appear -- to any of us. The merger of large institutions has negatives -- and positives. The potential effects of large mergers on the deposit insurance system offer us examples of why.

On the positive side of the issue, the consolidation of banks that serve different markets -- like the proposed Bank of America and NationsBank merger -- can diversify risk and decrease the volatility of earnings, moderate the effect of economic downturns on these institutions, and thereby decrease the likelihood of their failure. Diversifying risks works the same way in an institution as it does in a loan portfolio. And it is a historical fact that many of the institutions that failed or were troubled in the late 1980s and early 1990s tended to have geographical or product concentrations. Mergers can make institutions stronger than they otherwise would be.

At the same time, the resources and broader range of these banks should also enable them to compete more effectively in international markets, which is not a small advantage for our banking system in an era of global trade.

In addition, mergers between banks and other financial service providers -- like the proposed Citicorp/Travelers Group merger -- can benefit banking organizations and the deposit insurance funds in several ways. These combinations can bring new capital and additional management expertise to banking organizations, and open new opportunities to generate profits and to diversify sources of income by expanding the activities that banking organizations can conduct. Everything else being equal, the better capitalized, better managed, and more geographically and operationally diversified a bank is, the less exposure it offers to the deposit insurance funds.

Large mergers -- either between banks or between banks and financial service companies -- do present risks, however.

Obviously, the larger a single consolidation institution is, the larger the loss the insurance fund would experience from its failure.

In addition, insurance is based on diversifying risk. If an institution gets too large relative to the industry as a whole, it becomes increasingly difficult to diversify risk.

Mergers that create larger banking companies increase the economic impact if the new institution fails. And they may raise the questions of a systemic risk determination -- which in the old days, when things were simpler, was the determination by government authorities that an institution was "too big to fail."

Merging banks and other financial service companies raises an additional question -- a potential for expanding the federal safety net to non-banking activities. The lack of effective safeguards to separate the insured institution from other parts of the organization might lead to the expansion of the safety net -- and to the potential for additional losses to the deposit insurance funds should there be a failure.

Moreover, the sheer size and complexity of larger institutions and their involvement in more non-traditional activities can create challenges for regulators and management -- for example, ensuring the compatibility of information systems while addressing the Year 2000 problem.

In short, one can lower the discussion of the recently announced mergers to charges that big is good or big is bad, but in reality they have the potential to be good -- and bad -- as far as the deposit insurance system is concerned.

An area where the evidence is a bit more definitive, however, is in whether they pose a threat to community banks.

Unlike the situation in many other nations, the banking system in the United States is characterized by a large number of small, community-based institutions. Despite the trend toward consolidation, smaller banks still account for the vast majority of depository institutions and have demonstrated an ability to compete in their markets.

In fact, as of the end of last year, nearly two out of three commercial banks and savings institutions had less than $100 million in total assets. Community banks operate in over

4,000 communities in which there are no offices of larger banks, providing essential financial services to consumers and businesses. Community banks continue to serve as a key source of credit for small businesses and farms. They are often more aware of the financial health and credit needs of local businesses and can use this knowledge to profitably originate loans that might not be made by a larger, multi-state institution.

Many have raised concerns that the trend towards larger institutions will adversely affect the viability of community banks. However, there are many reasons to believe that community banks will continue to play a critical role in the financial system.

First, smaller banks have competed effectively in states such as California, New York, North Carolina and Virginia, where statewide branching has long been allowed.

Second, new community banks continue to be chartered. Since the beginning of 1995, more than 450 new financial institutions have been chartered with 200 of those being chartered during 1997. Many of the newer banks are targeting specialized niches, or products and services, to satisfy the needs of communities not being met by larger institutions.

Third, community banks continue to share in the extraordinary profits achieved by the industry over the past six years. In each of these six years, depository institutions with under $100 million in assets have recorded an average return on assets above one percent, the recognized industry benchmark for strong profitability. In 1997, small institutions earned an average ROA of 1.14 percent. Also, institutions with less than $100 million in total assets have the lowest rates of net loan charge-offs and the highest capitalization levels of any asset-size group.

Finally, community banks also compete effectively on prices and services. The Federal Reserve Board's most recent Annual Report to the Congress on Retail Fees and Services of Depository Institutions, which was published last summer, concludes that average fees charged by multi-state organizations are "significantly higher" than those charged by single-state organizations. Anecdotal evidence suggests that smaller banks and thrifts can gain customers when a local competitor is acquired by an out-of-area organization. Computerized communications may be leveling the field on which small and large banks compete by enabling smaller banks to contract for off-site, back-office support and to offer products and services from remote vendors.

While these facts demonstrate the continued vitality of smaller community banks, they do face strong competitive challenges from larger institutions. Economies of scale and other efficiencies available to larger institutions serving regional or national markets enable larger institutions to provide a wide range of competitively priced, traditional products and services, including savings and checking accounts and loans. In addition, financial conglomerates are better positioned to provide one-stop financial services, which also may include insurance of all types, mutual funds, stocks, financial planning, and other services. These institutions can target and market these services, enabling them to advantageously expand into new markets and identify likely customers. On balance, however, smaller banks, focused on service to a particular local community and taking advantage of competitive strengths resulting from that focus, will continue to have a place in the banking industry.

Another thing that is clear is that there must be some sort of modernization legislation to provide a framework for large mergers -- particularly those that cross current legal boundaries.

This modernization debate is nothing new for any of us. I know that we've been trying to "modernize" banking since I entered the business almost 40 years ago. But there are constantly new wrinkles in it.

The latest arose just last week, in the context of HR 10.

The Federal Reserve, as we all know, has taken the position that new activities should be carried out in affiliates of a holding company -- the corporate form that it supervises. In the meantime, the Office of the Comptroller of the Currency has taken the position that new activities should be carried out in operating subsidiaries of the bank itself -- not a surprising stance for the regulator of banks. The Federal Deposit Insurance Corporation has taken the position that -- from the viewpoint of risk to the deposit insurance funds -- one corporate form is no better or worse than the other, and banks should be allowed to choose which form best fit their needs. The FDIC is also a supervisor, however, and our state nonmember banks also have subsidiaries, which, not surprisingly, are often the location of activities approved by the states. Jerry Hawke spoke to this point with you this morning.

I think that it is an important point, because the vast majority of state nonmember banks are community banks, whose interests in the evolution of the banking system are just as important as those of national banks and financial conglomerates.

In 1695 an English clergyman, William Partridge, distributed a religious tract prophesying the world would end in 1697. In 1698, he released another tract, this one claiming that the world had ended in 1697 -- but no one had noticed.

The mergers that have recently been announced -- together with mergers yet to be announced but undoubtedly coming -- are major developments in the evolution of the financial system. They will bring changes in the way we -- regulators and bankers -- operate, and no doubt we will all likely have to make difficult decisions. They will force us to rethink our assumptions. They do not, however, herald the end of the world. They will mean that all of us will have to do business in a different world -- but we will still be doing business -- and state nonmember banks should find that new world as inviting as any other financial service company.

Thank you.

Last Updated 06/25/1999