Remarks
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In one way or another, every item on this conference agenda deals with the evolution of banking and financial services. It is fitting that we are discussing such topics in North Carolina, which, among all the states, provides perhaps the best example of this evolution. The direct descendent of the marriage of two Charlotte banks - American Trust and Commercial National - more than 40 years ago is today one of the largest financial services companies in the world - Bank of America. In fact, the state - indeed, Charlotte -- is home to two banks with more than $100 billion in assets, the other being First Union, where the late Federal Deposit Insurance Corporation Director C. C. Hope retired as Vice Chairman in 1985 after 38 years at the bank.

North Carolina is home to enormous and complex institutions. But of the 118 banks and savings institutions in the state, 108 are community banks with assets of one billion dollars or less - and 50 have assets of fewer than $100 million. So North Carolina reflects the wide range of institutions in the U.S. banking system today-a few very large institutions and many smaller ones. Some observers have referred to this as a "barbell-shaped" industry.

This evening I will discuss some implications that arise from a financial services industry that is increasingly bifurcated by size -- and complexity. And I will conclude with a few thoughts about this trend as it affects regulation and deposit insurance.

But first, let's look at a few simple statistics that illustrate this structural change. Fifteen years ago, 41 banking organizations held 25 percent of U.S. domestic deposits; today only seven organizations hold 25 percent of deposits. Fifteen years ago, the combined assets of small banks and savings associations with assets of less than $100 million were more than double the assets held by the largest bank in the country. Today, that relationship is reversed. Bank of America's assets are more than double the combined assets of all small banks and thrifts with assets of less than $100 million - all 6,000 or so of them. It was this structural transformation that brought North Carolina to the forefront of U.S. banking: At the beginning of the 1980s, the top three banks in North Carolina had total assets of $14 billion, and accounted for less than 1 percent of the nation's banking assets. Today the top three North Carolina banks have total assets of $866 billion, or 12.5 percent of the nation's banking assets.

Today, the difference between large and small institutions is not just one in degree, but also one of type. Bank of America - as an example - provides more kinds of services than any community bank does through its multiple nonbank subsidiaries and affiliates. It is a much more complex institution than if it were simply a community bank multiplied by thousands.

And -- with the passage of the Gramm-Leach-Bliley Act -- a stroke of a pen ratified years of incremental change in the structure of the financial industry - and could accelerate it by opening the door to the creation of more and larger diversified financial conglomerates. It is true that some smaller banks have also taken the first step to engage in new financial activities authorized by the new law. In fact, more than two-thirds of the recent applications to form financial holding companies have come from companies with total assets of less than $1 billion. With Gramm-Leach-Bliley, however, the largest institutions will only get larger and more complex.

Consolidation in banking, both domestically and across international borders, can be expected to continue, as banks strive to reduce operating costs and strengthen and diversify their revenue streams. So, even more than today, one end of the banking industry barbell could become the province of giants, firms that offer the full menu of financial services through integrated and technologically sophisticated delivery platforms.

What does this mean for community banks? Will community banks be able to compete?

The challenges facing community banks are well known.

These institutions traditionally have enjoyed wider net interest margins than their larger bank peers, in significant part because of their lower-cost core deposit base. That advantage can be expected to narrow over time as a result of funding competition from large banks, non-banks and Internet providers.

And community banks remain more dependent for their earnings on the net interest income from their loans and investments. In 1999, 28 percent of the net operating revenue of banks less than $1 billion in asset size came from non-interest income and much of that came from sources tied to traditional banking activities, such as service charges on deposit accounts. In contrast, banks over $1 billion in size derived 47 percent of their net operating revenue from non-interest income, including, for the largest institutions, significant amounts from trading revenues, investment banking fees, venture capital gains, and earnings on asset management and custodial activities.

Because of their smaller base of revenue sources, community banks' efficiency ratio, roughly defined as the amount of overhead expended to generate a dollar of revenue, was a full 10 cents worse in 1999 -- $0.68 versus $0.58 -- for small banks with assets of less than $100 million than for larger banks.

It would be a mistake, however, to extrapolate from these trends a conclusion that community banks cannot compete.

Why?

More than half of all small banks - commercial banks with assets of less than $100 million - have returns on assets exceeding one percent; and even though the banking industry's 1.31 percent ROA in 1999 was an all-time record, 28 percent of small banks had ROAs higher than 1.31 percent.

Further, some of the factors driving a wedge between large and small bank performance today are temporary - such as problems in agriculture, which have always disproportionately affected community banks.

In addition, the yield curve during the last few years has been, by comparison with other periods, unusually flat. This also will pass, although in the interim it has contributed to a tightening of net interest margins for all banks. Since community banks rely more on net interest income, this tightening in spreads has affected them more than it has affected larger banks.

I believe there will always be a profitable niche for institutions that provide strong customer service, have management continuity and experience in their local market, and occupy a position of trust within the community-in short, the values and virtues of community banking.

And I'm not the only one.

North Carolina, for example, is in the midst of a prolific period of new bank start-ups. Seventy-two commercial banks are currently chartered in the state, 28 of which opened within the past five years. Thus, nearly 40 percent of the banks headquartered in the state are less than five years old.

And new charters are on the increase around the nation as well, although the level of activity is below the peaks of the previous three decades. The 827 commercial banks around the country that were chartered in the last five years are not concentrated in any one region of the country. The Southeast, however, had more than 25 percent of community bank start-ups during the time -- and I refer in particular to the FDIC's Atlanta Region - Alabama, Florida, Georgia, Virginia, West Virginia, South Carolina and, yes, North Carolina. One driver of new bank activity has been the availability of displaced banking talent, and there are reports that many of the start-ups in North Carolina were launched by executives displaced by mergers. Other drivers include strong economic growth, potential niche opportunities in markets under-served by the larger banks, and the loss of local decision-making as local banks are consolidated into larger operations. And there is some evidence of a relationship between new bank chartering activity and the number of institutions sold or consolidated in merger and acquisition transactions.

So there you have it.

Market forces are dividing banking into two broad camps.

Regulators shouldn't make that happen - and regulators shouldn't stand in the way.

Regulators should, however, understand what is happening and do what we can to make sure that our necessary actions don't unduly burden institutions or carry unintended consequences.

As we implement the regulations for the new financial landscape we must be mindful of whether we are creating a competitive environment where large and small institutions can compete on an equitable basis. For example, could a small community bank today repeat the success story of Bank of America, or have we along with the markets institutionalized a structure that would prevent that from happening?

I see several challenges for regulators. First, as we look at safety and soundness regulation in an increasingly barbell-shaped industry, perhaps the most noteworthy trend from the FDIC's perspective is that most of our financial risk comes from the largest companies, which typically are much more complex than the traditional community bank, even though, as Fed Chairman Alan Greenspan recently pointed out, asset size "is obviously not necessarily correlated with complexity or risk." Assessing the risk in these companies is easier said than done, for as the industry evolves towards larger and more complex organizations, risks are becoming harder to measure and monitor. In the risk-focused supervision of the largest institutions, we expect to see increasing focus on some of the sophisticated approaches that are being explored today, such as capital requirements tailored to external or internal credit ratings, the use of market signals to enhance supervisory information, and a continued focus on understanding and using banks' internal risk modeling efforts.

As we develop these tools, however, we need to avoid drawing smaller community banks into a needless web of complex new requirements.

Already, small institutions do not have the same reporting requirements as large banks under Community Reinvestment Act regulation. Small banks are evaluated under "streamlined" performance tests such as their loan-to-deposit ratio and the extent of their lending within their assessment areas. In addition, the regulatory relief provisions in the Gramm-Leach-Bliley Act will have a substantial impact on the CRA examination process of small institutions: examination intervals will be extended for institutions that have a demonstrated record of performance under CRA.

Capital regulation is one example of where evolution in banking could lead us to consider changes in regulatory approach. The agencies are presently discussing the possibility of a bifurcated approach to capital adequacy standards, in which the risk-based capital calculations could be simplified for certain small, non-complex institutions.

These discussions are in the very preliminary stages, but I firmly believe that alternatives to a one-size-fits-all capital standard deserve consideration.

A bifurcated industry also raises important issues for the operation of the deposit insurance system. One issue relates to insurance coverage. As inflation erodes the value of the deposit insurance guarantee, some bankers believe that there may be a tendency for larger deposits to migrate to larger institutions that are perceived to be safer. This has led them to argue for indexing coverage to some measure of wealth or price inflation.

Another issue closely tied to the bifurcation of the industry is that large and small institutions are presently insured under the same pricing structure, even though they are exposed to vastly different risks and the complexity of their operations differs by many orders of magnitude. Moreover, regulators have access to significantly different information about large banks than about small banks. For example, through the pricing of debt and equity instruments, market participants provide information every day about the risks in large banks that is simply not available for most community banks. Just as in the case of capital regulation, a one-size-fits-all approach to pricing insurance may not be the best approach. The FDIC in fact has the statutory authority under FDICIA to establish separate premium systems for large and small institutions.

Another issue that has come forcefully to our attention-and that is indirectly related to the bifurcation of the industry--arises from the fact that banks' deposit insurance premiums can at times be driven by movements in the ratio of the insurance fund to total insured deposits. Consequently, the rapid deposit growth of a large institution, or a substantial deposit injection from a non-bank affiliate, can have immediate and substantial effects on the premiums paid by all other institutions. In concept, this is an old issue, since the growth of a small bank has always had some tiny effect on the fund's reserve ratio. But the increasingly barbell-shaped distribution of the industry, the potential for large injections of deposits-coupled with the zero deposit insurance premium most banks now pay--is highlighting the importance of the issue.

I have asked our staff to take a hard look at these and other deposit insurance issues in the coming months. We have scheduled meetings with industry representatives for this month. I have also asked that by mid-July, the FDIC staff prepare a set of policy options for consideration that will constitute the initial step in our re-examination of deposit insurance.

Who would have thought -- picking up a newspaper in 1957 and reading that American Trust and Commercial National were merging - that those two institutions would grow into North Carolina National Bank, and that it would grow into NationsBank, and that that would be transformed into Bank of America?

No one then could have.

Bank of America grew in response to market realities.

Our challenge as regulators is to avoid setting up unnecessary regulatory hurdles that would stymie any institution's flexibility to handle changes in market realities.

It will be a challenge to respond to the evolving new dual banking system - one part large, complex institutions, the other smaller, simpler institutions - but we have recognized the need to review what we do and how we do it.

As one North Carolinian banker said not too long ago: "Change is coming at us not like a freight train but like a speeding bullet."

Thank you.

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