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THE COMMUNITY BANK IN A NATIONWIDE BANKING SYSTEM

Address of

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The banking structure of the country is clearly in transition, and like any movement from the familiar to the unknown, some are excited by what they see ahead, some are apprehensive, and most will have reactions somewhere in between. As my title implies, I see a number of forces at work today that are pushing us firmly and inexorably in the direction of a more truly nationwide banking system. But I also see an important role in that future system for the alert, independently-owned community bank which seeks to serve its customers more efficiently and more completely than ever before.

Speakers at this Convention have no doubt reviewed the impetus given to the bank holding company movement by the 1970 amendments to the Federal Bank Holding Company Act. Those amendments did much more than put an end to the previous uncertainty as to whether the large one-bank holding companies would be brought under regulatory control. They removed the differences between multibank holding companies and one-bank holding companies, thereby giving both types of holding companies an incentive to acquire additional banks in States whose laws were either silent on the subject of multibank holding companies or affirmatively permitted them. In such states -- and at last count there were 34 of them -- statewide bnaking through the holding company form is not only legally possible today but an increasingly common phenomenon. At the end of June 1972, almost 1300 of the country's 13,812 commercial banks were subsidiaries of multibank holding companies -- and more such affiliations are announced with each passing day.

The 1970 amendments in addition changed the mandate given to the Federal Reserve Board with respect to the kinds of bank-related activities which it might authorize for bank holding companies. The changes were not the most precise, but the Board had made it clear in testimony and correspondence prior to enactment that it would construe the new statutory formula more liberally than it had the old formula and that it was receptive to using the new language of 4(c)(8) in such a way as to bring new competition into local markets for a variety of financial services throughout the country. It has done precisely that in the two years since the effective date of the 1970 amendments. Moving quickly along the lines it had indicated before enactment, the Board has authorized bank holding companies to operate mortgage companies, finance companies, factoring companies, trust companies, investment advisory services, credit card companies and leasing companies which utilize full payout leases in their financing arrangements. It has also authorized certain limited forms of data processing services, insurance agency activities and credit life and credit accident and health insurance activities.

The Board, on the other hand, has denied to bank holding companies authority to engage in equity funding, the general underwriting of life insurance, real estate brokerage, general land development activities, real estate syndication and general management consulting activities. In addition, it has deferred for the present any decision at all on the controversial question of whether a bank and a savings and loan association should be allowed to affiliate through the holding company device.

More important than its determinations to date as to what constitutes activities "so closely related to banking or managing or controlling banks as to be a proper incident thereto" is the fact that the Board has a continuing mandate from the Congress to define such activities with the power to add to or change the permissible scope of a holding company's activities. While the pace of general authorizations may slow down in the future, I have no doubt that new activities will be proposed by individual bank holding companies and decided by the Board on an ad hoc basis with the end result that the financial services which bank holding companies may offer will continue to proliferate.

The Board, with the full support of the Antitrust Division of the Department of Justice, has also made it clear that it will aggressively use the powers it has to encourage the geographic, as well as the functional, diversification of bank holding companies. Applications by bank holding companies to acquire financial service organizations outside their home States are growing in number--obviously because they raise fewer competitive problems than acquisitions closer to home. One recent estimate places at 24 percent the number of holding company applications falling in this category, and most are being granted by the Board so long as the activities to be conducted by the proposed affiliate are on the "closely related" list.

What we have, therefore, is a situation in which bank holding companies are broadening the range--and the geographic reach--of their services in ways which may be denied to individual banks themselves under State law if they are State chartered or under the National Banking Act if they are nationally chartered. Since Congress shows no disposition at this juncture to modify the 1970 amendments or to spell out more clearly the powers of national banks, those who oppose some or all of these developments have only two ways, realistically, to express their opposition: (i) by active participation in proceedings before the Board of Governors on proposed additions to the list of "closely related" activities or with respect to particular applications, or (ii) by urging a restrictive course of action of State legislatures throughout the country. You are quite properly pursuing both courses of action, but I would be less than candid if I predicted any significant change in the direction currently set by Congress and the Board of Governors--to wit, the rapid development of financial department stores organized as holding companies and operating without geographic restrictions except as to the receipt of deposits from the average retail customer.

The Administration's recommendations with regard to the Hunt Commission Report are likely to fuel further the impetus toward greater competition in the offering of financial services to the American public. Even if the Commission's recommendations with regard to Statewide branching, mandatory membership in the Federal Reserve System and regulatory reorganization are not accepted, the generally favorable response within the Administration to enlarging the powers of thrift institutions if their obligations are also enlarged means that in the future thrift institutions will be offering more and more services now provided exclusively by commercial banks. At the same time, their rate advantage over commercial banks under Regulation Q is likely to be phased out. It would, of course, be foolhardy to predict what the Congressional reaction to such proposals will be, but I am convinced that these changes will occur slowly at the State level, if not at the national level, as state-chartered thrift institutions seek the powers recommended by the Hunt Commission and accepted by the National Administration. As this occurs in one state after another, Congress is likely in time to equalize the situation for Federal savings and loan associations. And I would point out that the states, up to this point, have been more liberal than the Congress in removing geographic restrictions on the lending powers of their own State-chartered thrift institutions.

There are technological developments as well which point to an increasingly nationwide financial system. As our population and our general affluence increases, the use of electronic means to control the volume of money transfers required in this country will become mandatory, not just desirable. Bank customers may continue to resist the checkless society, at least for a while, but banks themselves and the Federal Reserve System, in their interbank transactions, will not have that luxury. As money transfer and check clearing procedures become more efficient through electronic means coupled with overnight handling of transit items, faster pickup, processing and delivery of depositors' check and fewer entries of the same check in the clearance process, all financial institutions will grow increasingly aware of the nationwide character of their transfer function. In time, I would expect bank customers themselves, through increasing use of bank credit card facilities and limited authorizations for the automatic payment of recurring household bills to appreciate the logic and efficiency of nationwide credits and electronic money transfers.

But will this kind of nationwide banking system have a place for the locally-oriented community bank which is itself so much a part of our national heritage? For at least three reasons, I believe the answer will be "Emphatically yes." In saying so, I part company with those who predict, usually with an interest of their own to advance, that the days of the independent, relatively small community bank are numbered. I submit that there are good reasons based in fact, why you also should take heart in the future of the smaller independent bank in this country so long as the will to compete survives.

First, the competitive pressures of increased diversification both functionally and geographically have been developing since at least the early

1960s. Yet new banks continue to be chartered in record numbers and the vast majority of them seem to remain independent. Thus, in the last twelve years, some 2075 banks have commenced operation -- approximately 15 percent of all banks in the country today. A substantial number of these banks were organized in the fastest-growing unit banking tates, but a similar number were formed in other growth areas as well. Exactly 699 of these new banks were chartered between 1960 and 1967 in California, Colorado, Florida, Missouri, New Jersey, Texas, Virginia and Washington -- all of which are States which permit statewide merging or statewide holding companies. Yet it is emphatically not the case that these new banks have largely been merged out of existence or acquired by multibank holding companies. As of June 30 last year, 457 of these 699 banks remained independent. Virtually all of them are profitable, growing institutions today. About 7 percent of them are on our problem list today, but we expect fewer of them there in the future as their managements gain experience and they become more firmly a part of their local communities. Only 8 of these 699 banks failed during the twelve years since 1960, as contrasted with 46 other insured banks that also failed during the same period.

If these newly chartered, independent banks are not performing a useful community service today, or if only large banks can survive in our banking system today, how can their profitability and continued existence as independent banks be explained? I would suggest that the assumptions and prejudices inherent in such comments are themselves at fault.

It is easy to forget, moreover, that more than 13,085 of the nation's commercial banks have less than 5 branches or facilities, that 9,483 of the nation's commercial banks operate from only one office and that more than 10,300 are under $20 million in deposit size. It should also interest those bankers with large branch systems that the greatest percentage growth in deposits over the last 12 years occurred not in <u>their</u> banks, but in those with only one facility while the next largest rate of growth occurred in those small branch banks with from two to five offices or facilities. I see no evidence from these figures that the smaller, independent, community bank is losing its vigor or its viability.

The second reason I believe the smaller, community-oriented bank will continue to be a significant part of our nation's banking system has to do with the illusory claims of economies of scale made by the nation's largest banks. When they talk of the economies of scale which large banks can realize but small banks cannot, they seem to be referring mostly to the ability to retain management personnel of increasingly specialized skills and to pay them more per capita than smaller banks. This is merely another way of saying that the same expense ratio for a larger bank produces more dollars to pay more people than a smaller bank may need in catering to <u>its</u> customers. But the customers to which the large bank seeks to cater may be very different than the customers to which the small bank seeks or needs to cater. And most of the large bank customers requiring specialized management skills in their banks will be commercial customers with increasingly sophisticated and increasingly international credit requirements.

If we return to the average retail customer, however, it does not appear to be the case that significant economies of scale can be realized once a bank reaches the size of $20 - $25 million in deposits. I have previously discussed the FDIC survey completed two years ago which surveyed changes in unit costs for a sample of 972 commercial banks as the volume of business increased in seven basic commercial bank services: demand deposits, time deposits, installment loans, business loans, real estate loans, securities investments and safe deposit box services.

We found for servicing demand deposits, a function which accounts in the typical bank for a majority of bank employees and for the largest component of direct costs, that for a 10 percent increase in accounts, cost increased only slightly less -- 9.68 percent. For three other functions -- time deposits, installment loan functions and safe deposit box services -- we found no significant economies or diseconomies of scale. Size did seem to bring economies of scale in only the three areas remaining: business loans, real estate loans and securities investments. But if we bear in mind that the economies of scale appeared to be small and decreasing (or virtually nonexistent) in the three bank activities that typically account for over 60 percent of total direct operating costs and 70 percent of total employees -- that is, the servicing of demand deposits, time deposits and installment loans -- then we can more easily explain the continuing ability of small banks to show healthy operating profits despite their reputed disadvantages in cost based on small size.

More recently, we completed a study as to the impact of automation on five of these basic commercial bank functions and found that a bank with $25 million in total deposits which automated its demand deposits, time deposits, installment loans, business loans and real estate loans tended to incur higher operating costs in all of these categories than banks which had not automated. These research results are based on a sample of 975 banks which participated in the 1971 Federal Reserve Functional Cost Analysis Program. The typical Functional

Cost Bank with $25.0 million in total deposits had $10.2 million in demand deposits, $14.8 million in time deposits, $3.6 million in installment loans, $5.8 million in business loans, and $4.3 million in real estate loans.

On average, operating costs were 8.5 percent higher for demand deposits, 15.0 percent higher for time deposits, 8.3 percent for installment loans, 17.9 percent higher for business loans, and 14.1 percent higher for real estate loans in banks purchasing computer services from a correspondent, a service bureau, or some other type of off-premises firm than they were for banks which did not automate. If the bank automated by setting up its own on-premises computer, operating costs were an average of 10.7 percent higher for demand deposits, 26.6 percent higher for time deposits, 13.6 percent higher for installment loans, 1.2 percent higher for business loans, and 12.7 percent higher for real estate loans than they were for banks which did not automate. There appeared to be some economies in operating costs in banks of this size when they automated only if they had a greater than average number of small demand deposit accounts.

While there were variations in individual circumstances in banks of this size that might alter the results, our research indicates that a small or medium-sized bank still facing the decision to automate one or more of these functions would be well advised to exercise great care in its cost analyses before proceeding. It may well be that automation makes economic sense only for banks of significantly larger deposit size and with more extensive office network than the typical $25 million deposit bank.

My third reason for believing that the smaller, independent community bank will play a significant role in the nationwide banking system of the future is its obvious acceptance by the vast majority of Americans. The continued chartering of such banks, their deposit growth and their continuing profitability are only a part of this story. The public acceptance and respect for community banks is a tribute to the quality of service offered as well as to the leadership of local banks throughout the country.

In the years since 1960, small banks have accommodated to, and themselves offered, many of the banking services first introduced by much larger banks. These would include, to mention only a few, time certificates of deposit in small denominations, Golden Passbook accounts, and bank credit card arrangements. Small banks have also been in the forefront of the move toward drive-in facilities, longer banking hours and minimum or no charge checking accounts. Many have initiated moves to higher rates of interest on savings accounts as market rates warranted. Today, small banks as well as large are receiving a favorable reaction from their customers with single monthly statements for all deposit and loan activity with the bank and for the convenience of 24-hour unmanned teller facilities.

Lou Harris, one of the nation's leading pollsters, recently completed the second of his surveys for the Foundation for Full Service Banks of the attitudes and opinions of the American public about banking and bankers. This new survey included samplings in ten large states, including California, Ohio, Illinois, Minnesota, Florida, and Texas as well as a nationwide cross-sample for check purposes. The results should be very satisfying to the locally-oriented bankers here today:

-- A higher percentage -- 73 percent to be precise -- of the people polled expressed a "great deal" of trust in commercial banks than in any other type of financial institution, with the percentage even higher at income levels over $6000.

-- 57 percent of those polled agreed that banks were changing and that in the past few years had really tried to get them to do business;

-- 62 percent agreed with the statement that banks and bankers are more important than nearly any other institutions in the community because they help individuals handle their money and help local businesses when they need it.

While there was a pervasive mood of criticism toward the best established institutions in the country, commercial banks scored highest in terms of confidence -- but this was accomplished by the expectation of real involvement in the community on the part of commercial bankers. People seemed well aware of the concern banks and bankers demonstrated in trying to help the local community, but they were also under no illusions as to what actually was being done. Commercial banks had more "excellent" or "pretty good" ratings than negative ratings with respect to the following:

-- contributing to the community
-- supporting community fund drives
-- making housing loans to middle income individuals
-- attracting new business and industry
-- helping local business to grow
-- helping individuals and their families solve their financial problems
-- helping to provide better housing
-- providing jobs and training for young people
-- helping to rebuild cities
-- helping public education
-- helping local government to solve its financial problems
-- supporting local hospitals.

But there were more negative ratings than positive ratings with respect to the following:

-- making housing loans to lower middle income individuals
-- making personal loans to minorities
-- making business loans to minorities

-- hiring minority group employees
-- helping the needy
-- helping to find solutions to racial problems
-- helping to eliminate air and water pollution

The answers to some of these questions indicated that people felt bankers were at least trying to do their part in the community -- even if the negative ratings suggested that sometimes they were not always successful. He also recommended, in view of the many who were "not sure" what banks were doing in some of these problem areas, that banks should make known, in no uncertain terms, the extent of their commitment and perhaps the effect of their efforts as well.

To those who question whether bankers should take a visible role in these problem areas, the people Harris asked were quite emphatic. By 64 percent to 20 percent, they thought bankers should take a leadership role in community problems, 80 percent thought bankers should be as involved as they are today or even more so in the leadership of their communities and 77 percent agreed that one reason bankers ought to be more active in their communities is that they and their banks benefit when the community is doing well. Harris concluded that people are turning to commercial bankers hoping that their record of solid accomplishment in the business world can be translated into help and concern in the community.

With a proven record of banking service to its community, public acceptance and respect, profitability and growth, the independent community bank has every reason to face the changing environment in which it will be operating in the future with confidence and enthusiasm. A will to compete and a determination to serve will assure your continued success then as it has in the past.

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