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PROTECTING AND NOT PROTECTING
THE SMALL INDEPENDENT BANK

Remarks by

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before the

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The Independent Bankers Association of America

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I am glad to join your Annual Convention, and to be a part of the discussions concerning some of the key issues facing banking today. The winds of change are blowing strongly through our financial system. They carry with them some problems and some opportunities, both for you and your colleagues and for me and mine. One troublesome difficulty is that some of the problems look like opportunities and some of the opportunities look like problems. We need to reason together carefully to sort out these challenges and to attack them constructively.

Some of these issues revolve around matters of Federal banking law and regulation. Since I am partly in that business, I think that you are entitled to know the general frame of mind with which I approach these issues. First and foremost from your point of view, let me tell you how I feel about the small independent bank.

I should admit at once two particular contributions to my background of thinking. First, I have been trained as an economist, and I bring the trappings of that profession to any appraisal that I make of the banking business. But, long before I took an economics course, I learned something else. In the little town where I grew up, it was a small, independent banker who first aroused my interest in banking, and who showed me how much a good banker can benefit his community. The combination of both those experiences very much affects what I have to say today.

Let me summarize my major points in a few words, and then return to each one to elaborate my reasoning and to provide a few examples.

> First, I believe the small but well-run independent bank can provide some special economic benefits to its customers, its community, and the nation at large.
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> Second, I think the small independent bank is vulnerable in some respects to disadvantageous forces that can come both from

within the banking industry and from without, and needs and deserves a measure of protection against those forces.

But third, I believe some of the protections provided or sought for small independent banks are misdesigned or have been rendered obsolete by the onrush of events, and consequently our communities are not realizing all the benefits which they could and should enjoy.

Given these circumstances, it seems to me there is good reason for the current ferment of reform concerning financial laws and regulation to extend to the small independent bank, but such reform needs to be carefully and wisely tailored if it is to make our communities better off rather than worse.

Now let me expand a bit on each of these points in turn.

What is special about the small independent bank?

I expect we are all generally aware of the many benefits that a good banking system can confer upon a country. Some of those benefits flow in greater measure from one type or group of banks than another. For purposes of this discussion, however, I want to focus on those benefits that can be especially conferred by the operation of a small independent bank. To my mind, two such advantages stand out above all others.

One is entry into the banking business. All new bank managements start out as small independent banks--virtually by definition. And new banks--new outlets for banking services where customers can find a new and different set of bankers to deal with--are one of the most vital elements in our banking structure. They represent opportunities for innovation, adaptation to changing community structure and interests, and invigoration of competition that are well-nigh indispensable to a progressive banking system.

The second kind of benefit I have in mind is more cumbersome to state. I think a small independent bank can produce a banker who has known his community long and well enough to understand the long-run best interests of his customers and his community, and who feels his fortune sufficiently tied to those long-run best interests to make his own credit and service decisions based upon them. Note that I said "can" and not "does." The corporate structure of a small independent bank accommodates this kind of banker strategy, but it does not guarantee it. I have known small-town bankers who found the status quo too comfortable for them to upset by introducing some new customer service. I have known others who were too sentimental about Main Street or some long-time farmer customers to make objective credit decisions concerning them. On the other hand, I have known branch bank managers who have involved themselves deeply in their adopted community and who have time and again made decisions that avoided the temptations of short-run profitability in favor of building the long-run financial strength of their customers. But as a general tendency, I believe the small unit bank has the edge in leading the banker to associate his own personal welfare with the long-run best interests of his customers and the community.

I do not want to be misunderstood here. I do not regard the above two special benefits as overriding all others. There are other aspects of banking--efficiency, technical expertise, and service innovations--in which other forms of banking organizations have enviable track records. What I am trying to do in this discussion is to pinpoint those special attributes of small independent banks that deserve to be carefully nurtured.

Points of vulnerability that warrant protection

The small independent banks that offer the above-described benefits are also vunerable in certain respects to forces around them. Public policy can counter some of these or moderate them constructively, in ways that I believe advance the broad public interest.

For example, it typically costs more per item to process a small number of banking items than a large number. There are limits beyond which this kind of efficiency does not appear to be registered in bank earning and expense figures, but the evidence to date does suggest that the further below $20-25 million in deposits a bank is, the more it may suffer higher per-item costs because of its volume handicap. These economies of scale are legitimate cost savings which the customers of larger banks should not be denied, but there are certain governmentally levied charges for doing business that have been lightened for small banks and which help offset their cost disparity. Thus, with all other small businesses, small banks enjoy a lower income tax rate on their taxable net profits than do large institutions. Similarly, Federal Reserve reserve requirements have long been set substantially lower for small banks than for large ones.

Another area in which a small independent bank can suffer a troublesome handicap is in obtaining equity capital. I need hardly explain to this audience why that is so. One of the avenues often used by smaller banks to obtain an infusion of new capital, particularly in connection with changes in controlling ownership and management, is the organization of a one-bank holding company. The tax laws enable certain savings through such a corporate arrangement when an owner borrows to buy stock. In addition, the Federal Reserve allows more liberal debt-to-equity ratios for one-bank holding companies when warranted as part of a change in local ownership of a community bank.

A more insidious threat to small independent banks can arise if large financial institutions drawing strength from a number of markets should try to bid for funds or offer services through their own competing local outlet at temporarily unprofitable rates simply to attract customers to them. This kind of effort to break the back of less powerful local competition has been so strongly criticized in a variety of industries that Federal laws have been passed to try to prevent it. Nonetheless, it can emerge in subtle ways, and examiners and law enforcement officials have to be alert to stamp it out.

Some ideas for protection go too far

Some elements of current or suggested protection for the small independent bank, however, strike me as going too far. For example, in efforts to protect local banks from predatory outside competition, some jurisdictions have severely constricted the chance for new banks to enter their territory. Carried to an extreme, this kind of policy can deny the affected communities all new bank entry and the accompanying promise of more vigorous competition in the variety and costs of banking services.

Coming closer to home, I think interest rate ceilings on time and savings deposits are sometimes viewed in an overly protective light. The Federal regulatory authorities oftentimes are bombarded with plausible arguments as to why an increased deposit rate ceiling cannot be tolerated by particular institutions--and sometimes they are persuaded by what they hear. In the case of small town banks, the argument is sometimes accompanied by explanations that for reasons of convenience, convention or borrower relations, it is impractical for them to recover the cost of higher time deposit rates by raising rates on their local loans.

Underlying developments, however, seem to me to be evolving in an opposite direction. With depositors free to move their funds and nationwide communications and funds transfer systems becoming increasingly pervasive and efficient, the chances are gradually dwindling for holding funds in local communities while paying them rates far below what is available elsewhere. In the broadest sense, paying below-market rates for deposits while charging below-market rates for loans is asking the savers in effect to subsidize the borrowers. Among its other drawbacks, that procedure is indirectly inflationary, since it discourages savings and encourages borrowing to some extent at a time when we are being plagued with a virulent inflation that demands the best combined efforts of all of us to brake.

Unpopular though it may be with you, I must also say that I regard Federal Reserve reserve requirements in a similar vein. Most small nonmember commercial banks--and most other institutions as well--contend that meeting Federal Reserve reserve requirements would reduce their earning assets and their earnings. Some calculations I have seen exaggerate that earnings effect, and give inadequate weight to the accompanying privilege of using the Fed discount window in time of need. Nonetheless, I appreciate the cost concerns that member and nonmember banks alike have regarding reserve requirements. I take that as indicative to the Federal Reserve that it ought to do what it can to adjust reserve requirement percentages (and also the implicit value it returns in services it supplies to those institutions meeting its reserve requirements) so as to limit and distribute that reserve burden equitably. But it does not seem fair to me for many banks not to share in that burden at all. Nor does it seem fair to me for more and more thrift institutions to enter the field of supplying demand deposit-type services without bearing the demand deposit reserve requirement set by the monetary authority.

Furthermore, if more and larger banks keep voluntarily withdrawing from Federal Reserve membership with its obligatory reserve requirement, the resultant smaller and smaller reserve base will make monetary policy progressively harder to conduct effectively. Yet, in the inflation-plagued world in which we are living, financial institutions have a fundamental stake in an effective governmental anti-inflationary apparatus. It is in your long-run interest for the mechanisms of monetary policy to be strengthened, not weakened, in a decade like this one. Accordingly, I commend to your further and far-sighted contemplation the recent Federal Reserve proposal to make its reserve requirements applicable to all institutions accepting demand-type deposits.

Needed: a careful transition

I know that some of the elements of presumed small-bank protection which I have just criticized would, if removed, pose difficult adjustment problems for many small independent banks. To maintain adequate earnings, small banks I believe would need to develop new types of deposits and fund-raising instruments, and more flexible interest rate policies regarding many of their loans. These kinds of changes in service pricing can take years to complete, especially in smaller communities. Accordingly, I certainly would advocate comparatively long-lived and liberal provisions for the gradual phase-in of any relevant public policy changes in order to make the transition easier. The

Federal Reserve Board has gone on record in favor of liberal transition arrangements in its own statements concerning its proposed reserve requirements legislation and also concerning the Hunt Commision and related proposals for eliminating interest rate ceilings on deposits.

Making broad-gauged changes in the laws and regulations covering financial institutions is a tricky business, in which many interests collide and a welter of arguments and counter-arguments appears. I think, though, that there are two guiding principles which can help all parties involved to move in a constructive direction. One is to weigh the desirability of all proposed changes in terms of whether or not they are likely to produce improved services to customers and communities over the long run. The second is to judge the equity of proposed changes by whether they move in the direction of making all financial institutions which perform the same functions subject to the same kinds of governing rules and regulations.

I assure you the Federal Reserve is trying its best to be guided by these principles in its own activities affecting the financial structure. I commend them to you as well. I hope you will communicate with us quickly, clearly and vigorously if and when you see effects of our actions which you think are contrary to those principles. And I hope you will support us when you believe we are applying them well.

If the laws and regulations protective of small independent banks can be brought into general alignment with those principles, I am confident public policy will have made its proper contribution. It behooves all of us to remember, however, that by all odds the best protection for the small independent bank is the independent banker who, from the time he unlocks the front door in the morning until he goes home at night, makes his decisions with the best interests of his customers and his community clearly in view. I, for one, believe there are enough bankers like that in this country to keep small independent banks a valuable part of the financial scene for as far ahead as I can see.