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Will Small Banks Survive?

Remarks of George W. Mitchell

Member, Board of Governors of the Federal Reserve System

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Commercial banking in the United States is as old as the nation, but in a real sense the banking system collapsed and was reborn in the early 1930's. Its rebirth was a partial reincarnation of earlier institutional forms and arrangements but in the wake of the drastic economic contraction of the late twenties the structure and the ideology of banking was transformed and a chastened ultra-conservative spirit dominated its operation for most of the next two and one-half decades.

We are now witnessing another banking transformation brought on by a new banking ideology, a largely unforeseen technological revolution in credit and settlement accounting, and a large and steady flow of savings from a prosperous American economy.

In this latest maelstrom of change there is apprehension in some quarters about the survival of the small or moderate-sized community bank. Will it suffer the same eclipse in economic significance as the corner grocery and independent merchant? Will it be replaced by a branch of a large banking institution? Will it be loosely linked in affiliation with other like banks in some central organization, such as a holding company, that provides portfolio management, personnel training, computer facilities, and other overhead services? Or will it somehow struggle through these new challenges and emerge onto the new frontiers of banking, modernized but still preserving the sturdy independent tradition?

Before turning to a discussion of these questions, some helpful background will be provided by considering how the evolutionary changes of recent years show up in an over-all look at the structure and business of banking. Forty years ago banking services for the United States were provided by 32,000 offices, operated by 29,000 banks. At that time there was a banking office for every 3,700 people and banking was enjoying a golden age of prestige and affluence. The structure of banking that came out of the wringer in the early thirties, though modeled on that of the twenties, had but half the number of service facilities previously available; there were now about 8,000 persons per banking office. Since that time, banking offices have increased steadily and somewhat more rapidly than population. Today there are 29,300 offices serving the general public, operated by 13,800 commercial banks. The scale of banking today provides an office for every 6,700 persons.

These persons are at least 10 times as rich as 1934's banking customers and they use a great deal more credit--165 times as much bank instalment credit, to take an extreme example. Or to employ a more representative comparison, all of the banking system's loan customers--corporations, businesses and individuals--have recently been using as much as $200 billion or 13 times as much bank credit as they drew down in the mid-thirties.

As banks' customers have grown in number, affluence and readiness to use the banking system's credit facilities one might have expected their checking account balances to have grown proportionately.

But, as you know, this has not been the case--the over-all figures show only about an eight-fold increase in demand deposits since 1934. In recent years banks have sought to offset, in some measure, the slower growth rate in demand deposits by stepping up their efforts to attract time accounts. Today, the balances in these accounts are 11.5 times as large as in 1934, indicating that bankers' efforts in this direction have met with considerable success. Of course, success has had its price. In 1965, banks paid their time depositors nearly $5-1/4 billion in interest; the average rate paid to savers was about 3-3/4 per cent. In the late thirties, banks made interest payments of about $225 million at an average rate of 1.5 per cent.

The over-all statistics I have been reciting are reassuring, for they suggest banking has regained a position of size and influence in the national economic community. But they don't tell us much about banking's ups and downs in the past 30 years nor do they reveal changes--and very important changes they are--taking place within our economy and within the banking and financial structure itself. Some of these changes have important implications for the community bank.

The diverse population trends in the United States are a case in point. Where people stay or move to is fundamental to community banks since such banks are basically oriented toward individuals and small business enterprise customers.

Population in the United States in the past 30 years has been on the move. Despite eddies and backflows, the predominant movements have been from the East and the North to the West and the South, from the farm to the city, and from the central city to the suburbs. Since established banks in many sections of the nation, particularly in the Midwest, the South and the East, are tied to their original location these population movements have had widely disparate influences on bank growth. The bank fortunate enough to serve a growing area prospers from the flow of new investment, larger payrolls, and aggressive-minded business community.

The bank unfortunate enough to serve a stagnant or declining community is hard pressed to hold its position, let alone grow. The poor prospects for the community limit the number of bankable local loans and, correspondingly, the bank's participation in the economic life in the community. If declining economic conditions continue, it becomes increasingly difficult to replace the bank's management when that necessity arises even though the community continues to need a banker and banking services.

Growing urbanization in the United States is a threat to community banks as we have known them because so many are located in stagnant small towns or in shrinking agriculturally orientated communities. To give a pertinent statistical fact, in the 10 years between 1950 and 1960 population declined 10 per cent or more in nearly 50 per cent of the 830 counties of the United States having 10,000 or fewer persons.

In the United States there are, outside of standard metropolitan areas, 7,700 cities or towns with only a single bank. There are 1,800 places where there are only two banks. In the one- and two-bank towns are found three-fourths of the banks in the nation. Most of these towns are small--one-half of them have populations of less than 1,000; only 10 per cent have populations of over 5,000.

The number of these rural towns or places has changed hardly at all since 1940. The total population in the places of less than 1,000 population declined 7 per cent and in places between 1,000 and 2,500 increased 11 per cent. But in the country as a whole, population increased 36 per cent in the same period, and in the standard metropolitan areas, where nearly two-thirds of our citizens now live, it increased 52 per cent.

Thus, the overwhelming proportion of our community banks are in towns that have ceased to grow or are losing population, or are growing very much more slowly than the urban areas. While there are places where credit needs and business investment grow, despite a lagging population trend, the outlook for a community bank by its very nature is ordinarily closely linked to people, more people and richer people. Failing this prospect, unit banks, anchored to the community they serve, face a future of limited opportunity.

For this very unfortunate reason then, most of the small banks in the country have little cause to fear or expect that state-wide branching systems or holding companies will swallow or annex them. Such managements with aggressively expansive intentions have little interest in areas showing less than average growth. And for large numbers of our community banks the perils of encroachment from the outside are insignificant compared to the perils of economic stagnation and decline coming from within their historic service areas. Yet few of them seem apprehensive about these environmental trends and they do not complain to the Federal Reserve or to the Congress, so far as I am aware. I presume this means they enjoy a pace of life and a peace of mind that their growth-minded counterparts in the cities have forgotten exists.

Let me turn then to the problem of the community banks in cities, towns and metropolitan areas where a substantial growth pattern is embedded in the economic environment.

My four-year experience in passing on bank merger and holding company cases brought before the Federal Reserve Board has convinced me that an important factor accounting for the failure of well-located and well-operated community banks to resist the trend toward larger branching and holding company systems springs, in important part, from the lack of broad-based local support for community banking. Seldom, indeed, do the submissions to the merger record before our Board contain evidence of community preference for a locally-owned and operated institution.

On occasion we do get a vigorous advocate of local banking, but it is usually a one-man crusade. Let me quote from portions of correspondence I had with a businessman with strong convictions about a community bank that had been merged into a state-wide branching system. This was his opening shot.

"An alarming situation with growing intensity is developing in America. It is threatening the very foundation of our community life.

"Community banks were organized for the purpose of serving the people, by groups of public spirited men, not for profit. Great sacrifices of time and effort went into the organization and operation of the banks for the good of widows, orphans, small depositors and small borrowers, at reasonable rates. These men even pledged themselves to double jeopardy (twice the value of their stock) to assure the success of the bank. The bank was likened to the church, the school, service clubs, and other community benefits.

"I am sorry to say the Federal Reserve has been a party to the gradual destruction of this beautiful community-bank-local-citizenry relationship by submitting to wholesale mergers throughout the nation.

"For example, a big, big bank sent their cleverest persuaders to the bank in our small town four years ago. They found an aging president and cashier. Question: Do you have a pension system? Answer: No. Question: How would you like to be pensioned under our retroactive pension plan? Answer: Obvious. Question: Do you own much stock in your bank? Answer: Quite a lot. Question: Would you sell it or accept our stock at nearly twice the value of your stock? Answer: Obvious.

"The new management is far removed, 50 miles, from us. Local directors were replaced by 'advisory boards': puppets.

"A local man can no longer prove his worth as able and capable of showing proficiency in his own business and to build good will among once local directors, who now live in a far off city, and who can never know his problems or those of the community.

"Gone! Gone is the legal rate; gone is the local touch, gone is the desire to serve; gone is a way of life."

My reply was as follows:

"As one member of the Board of Governors of the Federal Reserve System, I recently read your letters about bank mergers. Although you have already received an official reply I thought I might add an additional personal note.

"I assure you that the displacement of locally owned and operated banks by branches of large institutions with non-locally determined policies is a matter of concern to me and other Board members.

"The possibility that a given merger will lead to adverse consequences of the kind that concern you is a matter that is reviewed in every case that comes before the Board. Our examiners look carefully into facts touching on this possibility, such as the quality and cost of existing banking services in the area, and the attitude of banking customers in the community toward the proposal. The records before the Board in merger cases frequently show beyond any reasonable doubt that the affected communities will be better served after the merger than before.

"There is a great deal to be said, in my opinion, for protecting and fostering local institutions, and especially those having to do with the extension of credit. But you put a very typical case when you referred to the bank whose owner-manager, aging or in poor health, is looking for someone to take over. The record often shows that he looks in vain locally for successor management or ownership. I think you will agree that this presents an especially perplexing situation.

"People in the local community who feel as you do, and who may have organized the bank in the first place, should know first-hand when new bank management and ownership is becoming a critical problem. If they want their bank to be a local institution, they should act to renew or replace its management and they should formally oppose merger until they have had a chance to do so.

"There is another alternative, namely, chartering a new institution. But in many small communities there isn't enough business for two banks, and this makes timely action to retain local control of the existing bank most important.

"We are certainly aware that good banking services are essential to any community's welfare. To the best of our ability this is what we are trying to safeguard. But we must act on the facts laid before us by the applicant, the community, and our examiners. It is in this light that our decisions under the Bank Merger Act of 1960 are made."

And here is his "last" word.

"While I felt my letters would be shown the Board, I am more than gratified to get a reply from one of the members.

"It grieves me to know that for three years so many of our people could have been so downright apathetic. Many complain orally, because they find it too late; some through fear, some for lack of prior notice. Others may say: 'Oh, what's the use,' or 'Let George do it,' I do not know.

"The aging president of the previously referred to bank, held a large block of the bank's stock, perhaps typical of other small banks. The sale of his bank stock held a much keener temptation than transferring his job to a younger man.

"The scores of smaller stockholders had looked to him for years to run the bank and were easily swayed. And let us not forget, the big city banks have highly skilled and well-trained persuaders to approach the little bank and to approach your Board. They come to you with hat in hand, but return to the small community with a determination to get every drop out of that community--and do.

"I do wonder in three years how many outside the benefitted 'parent bank' have sent letters of praise to your Board for merger approvals. 'Little Red Riding Hood' learned the hard way, so did the people of Hamelin."

My correspondent may have exaggerated--and I have deleted some of his more colorful language and ideas--but most of us would grant that he speaks for a part of our banking system we would like to see preserved--even if partly because of nostalgic associations.

Can the community bank in a growing area compete with large branching systems and prosper? We see plenty of evidence that it can be and is being done; there also are numerous cases where it is not being done.

If the community bank is strongly rooted in the area it serves I am sure you know better than I that the typical individual and small business customer will usually prefer it to the branch of a nonlocal bank This is a great and a dependable natural advantage for the community bank.

On the other hand, there are some disadvantages of smaller size--mainly that certain banking features, such as trust services, cannot be offered because they are too infrequently demanded to warrant the cost of furnishing them and, secondarily, the inability of small banks to realize, on the cost side, economies of scale that large banks enjoy. However, in theory and actual practice a community bank often needs no more than a well integrated correspondent relationship to secure the accounting services, the portfolio management, and other facilities that cost-wise must be spread over a larger volume of business than a community bank can generate.

In many, many cases the demise of the community bank is tied to the lack of community support--a fact that my correspondent so bitterly decried. I have the feeling that this lack of community support is related to the concentration of ownership in small banks. There is much concern about concentration in banking and concentration of ownership in certain large banks but perhaps not enough attention has been given to the concentration of ownership in small banks.

When a branching system sets out to buy up a small community bank of the kind my correspondent described, how many stockholders are there to sell on the idea? Not many, to judge from the best evidence we have. From a survey taken of some 5,600 member banks in 1962, we estimate that twenty <u>or fewer</u>--and I emphasize "or fewer"--stockholders hold 90 per cent or more of the shares in one-half of the country's smallest banks--those with less than $5 million in assets.

From the same source we can estimate the degree of ownership concentration more strikingly if we group what appear to be common stockholders' interests. Assuming that individuals with the same name and living at the same address can be regarded as a single "stockholder interest" the survey indicates that in the same group of small banks the average amount of stock held by the three largest identifiable stockholders' interest is 55 per cent.

These figures show an extremely limited community participation in the ownership of local banks. In many cases it is evident from the addresses of the owners that, while at one time they may have been active residents of the community, they are now absentee owners whose local interest is diluted by inheritance, distance, retirement or greener pastures.

Given these facts, it does not seem surprising to me that community banks fail to generate a ground swell of local opposition to mergers with nonlocal interests. Frequently, the only change is the substitution of one group of absentee owners for another. Frequently, the performance of the local bank in meeting community needs is too flabby and too backward to arouse anything but negative enthusiasm. Frequently, the outside bank imports better services, more credit and competitive prices and terms.

The answer to the survival of the small bank in the growing community, if there is one, may well lie in making the local bank a truly community institution with a wider ownership among the businesses and citizens in the area and a wider participation by the bank in financing local operations and activities. This is the kind of bank we see in our mind's eye when we seek to preserve local management and local administration of credit resources.

But perhaps we ought to look around and see if the bank we have in our midst resembles the image in our mind's eye--if it does not, this may be the clue to measures needed to insure survival of our community bank.