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of the
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The Public Interest in Uncongenial Interbank Relations

Up to now this convention has been an enjoyable one for me. I have certainly encountered nothing here that is at all reminiscent of the reputation Illinoians had at a much earlier period in history. When Lincoln represented this great state in Congress in the 1840's (around the time my father was born in Whiteside County, just north of here), a dispute arose among the Congressmen about the proper pronunciation of its name. Some contended that it should be Illinois and some Illinoiz. The dispute was taken to the venerable John Quincy Adams, and that great statesman rendered the following verdict, "If one were to judge from the representatives in this Congress from that State, I should decide unhesitatingly that the proper pronunciation is All-Noise."

I am sure that if Adams were alive and with us today he would revise that harsh judgment. I only hope that what I have to say will not be marked down as all noise, even though the subject I want to discuss - bank competition - is one which has come in for a great deal of noisy debate in recent years.

In focusing our attention on this subject, you and I will have plenty of company. Over the past year or so, financial circles and the press have given a great deal of attention to a variety of supervisory actions that have affected the structure and competitive atmosphere of the banking system. I have in mind particularly the amendment of Regulation Q to raise the ceiling on interest on time and savings deposits, the stream of bank charter, branch, merger, and holding company actions, Justice Department charges regarding restrictive practices among banks, and a succession of reports of study groups and commissions, such as the Commission on Money and Credit, the Advisory Committee to the Comptroller of the Currency, and - most recently - the President's Committee on Financial Institutions.

It could be, of course, that press coverage of all kinds of events has simply been increasing in breadth and depth - some evidence of such a trend is to be found in the

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fact that my home town, Broken Bow, Nebraska, recently found itself on the front page of the Wall Street Journal. I think it more likely, however, that the reason for current interest, both journalistic and general, in banking matters is that a lot has been happening - frequently accompanied by sharply differing opinions among supervisory agencies and some resulting lively arguments.

The emphasis placed on government regulation by this kind of attention may make some bankers, in their darker moods, wonder if their industry isn't being nationalized - rather than just regulated. They may feel somewhat like the little boy with the fake steering wheel attached to the dashboard watching his father do the actual driving. But the fact of the matter is that it is bankers themselves who do the driving; the supervisors merely license the drivers and establish the rules of the road which will make it possible for them to get where they are going quickly and safely. Parenthetically, perhaps I should have suggested that they are driving busses, presumably in competition with each other, and therefore have to provide routes, destinations, and service that will bring them passengers. Then one could readily see the need to establish regulations and basic rules of the road. How quickly, indeed, do we leave behind Walden Pond and the footpath through the woods; but then Thoreau did not care about being a bus driver - or a banker.

The point I wish to make today is that the kind of attention that has been generated has tended to reverse the proper emphasis on the course of events. I suspect the impression has been given that the supervisors are initiating actions in a range of new areas or with respect to a range of new problems. The fact is that the primary determinants of regulatory actions, and of over-all banking progress, are - and should be - the bankers themselves.

This contrast between appearance and fact reminds me of the circuit-riding preacher who used to travel through the sandhills country around Broken Bow. His horse went lame as he came through town one day, and he went to the local horse trader to buy a new mount. As it happened, the trader had one good-looking but particularly fractious beast that no one

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around home had quite been able to handle. The trader was a good Presbyterian, and so it hurt his conscience to think of inflicting this horse on a man of the Gospel. But he was also a good horse trader, and so he sold him the horse for thirty dollars. The preacher managed to get astride and head out of town, and that was all that was seen of him for about a month. Then one day he returned on his circuit - rider and horse galloping smoothly as one across the prairie. The trader could not resist remarking to the preacher about his obvious ability to handle a horse that had defied some of the best hands in Custer County. "You sure sit that horse nicely, parson!", he said. "How did you manage it?" "Well," said the preacher, "it took a lot of patience and practice before I learned to act as if I wanted the horse to go where it had already got it into its head to go."

I am sure some of my colleagues on the supervisory side of the fence join me in the occasional feeling that the banking system has "got it into its head to go" various places, faster and farther than supervisors deem appropriate. On the other hand, once in a while a supervisor comes along who seeks to dictate where banks must go, and how fast, regardless of their wishes. Frequently, in both cases, the loud sputtering one hears is only the prelude to a fizzle. But the achievement of real progress depends on getting both going <u>together</u>, in the same direction - the direction of development and growth, commensurate with the credit needs of the community and the nation, and compatible with the maintenance of a safe and sound banking system.

In many ways, of course, both the initiative in banking developments and the restraints upon the scope of banker action are provided by the existence of competing banks. Fundamentally, ours is a society wedded to the competitive process as a chief safeguard of the public interest. Most of our laws with respect to banking are designed to try to promote the effective functioning of competition. Both our statutory measures and supervisory actions have usually been introduced in reactions to competitive practices on the part of banks that were regarded as inadequate or inappropriate.

I suppose there are few better examples in this respect than the legislation that gave the Federal Reserve

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Board the power to promulgate Regulation Q, limiting maximum interest rates payable on time deposits. The painful "rate wars" of the 1920's, and their aftermath, were clear in every mind's eye when this measure was adopted. The purpose in establishing a ceiling on such rates was not to halt competition but rather to confine it within viable limits. That is in no way inconsistent with an interest in "healthy" competition. I know of no contest short of war that is not played with white lines or the equivalent, including a family game of touch football - and even there someone is apt to move the sweater that marks the goal if no one is looking.

The raising of the interest rate ceiling in December 1961 was a moving back of the boundaries to give the players more room to maneuver. It was not a regulatory rigging of the game. It was a step away from regulation, taken in the belief - or at least the educated hope - that such increased leeway for free competition could be afforded without undue risk to adequate and sound banking.

As you know, banks responded by raising their rates with alacrity, and the sharp response of their customers led to a much enlarged flow of loanable funds to some of the basic investment sectors of the economy - for example, housing and state and municipal facilities. In addition, the step served to reduce the obstacles to effective competition between banks and other types of financial institutions.

The results of this pattern of action over the past year have not, I am sure, always proved comfortable to bankers - what with the increased cost of operations and the difficulties of finding profitable outlets for funds - but that was not its purpose. The acid test of this action can be stated in the form of a question. Have commercial banks proved sufficiently competitive to exploit the higher range of permissible rates to the benefit of both themselves and the public but also sufficiently responsible in their response to market forces of supply and demand to carry such rate competition only to reasonable lengths? I shall not answer that question; the facts that would support an answer in each particular instance are more in your possession than

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in mine. I will point out, however, that what was being tested was not Regulation Q, but the competitive mettle - and responsibility - of banks themselves.

There is another area of bank activity that currently seems to me to be providing just as clear, though not as dangerous, a case of "bank competition gone wrong" as did the interest "rate wars" of the 1920's. I am referring to those competitive bookkeeping manipulations that are sometimes euphemistically termed "year-end adjustments" - "window dressing" to you and me. These machinations, whether accomplished by round-robin deposit arrangements or otherwise, do not fit into the image of the industry that bankers have sought to project.

There is little doubt as to how a good banker would react to a borrower's statement that was inflated to show a more liquid position or a larger volume of business than in fact existed. To the degree these efforts succeed, they result in deceiving the public. And, to the degree they are recognized and discounted, they result in raising doubts as to the reliability of bank statements and of bankers' statements.

Window dressing, designed to move an institution up a notch or two in the American Banker's list of the largest banks, may reflect an intensely competitive spirit; but this kind of competition, unlike the product and service competition upon which our efficient free enterprise system has been built, tends to be self-destructive and does no credit to those engaging in it. Of course, it really is not competition at all. It is more like an exercise in "How to succeed in business without actually trying", and as such belongs more on the Broadway stage than in banking.

Another competitive evolution in banking - one that is almost reaching the dimensions of a revolution in some areas - is being wrought by the stream of applications for bank charters, branches, mergers, and the affiliation of banks in holding company systems. These pour in on the supervisory agencies, numerous as aspirin tablets - and you can guess why I associate the two.

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Illinois, of course, is a sea of comparative tranquility in this respect, at least on the surface. What lies beneath the surface I shall wait for you to tell me. The hint has come to me that the subject of your state's statutory policy in this field may not be as securely entombed among you as are the revered remains of your most famous citizen, Mr. Lincoln. But I would be rash, indeed, if not impolitic, to inject myself into the debate. Since I do not propose any tampering with the dual banking system or the freedom of each state to determine the structure of its banking system, my remarks are those that seem applicable to whatever framework a state may have chosen - or may choose in the future.

In most applications - charter, branch, merger, or holding company - that come before the supervisor, two key elements are the state of competition within the relevant banking market, and the adequacy of bank services. The laws that we administer call for careful attention to both of these elements in reaching judgments as to approval or denial of the applications. Here again, the nature of those judgments is determined in a major degree by the banks in the community.

If the community is characterized by lackadaisical competition or by a convenient network of "gentlemen's agreements" that make the banker's life more comfortable, the participants will have done much to foreordain the eventual decision of the supervisory authorities. This kind of situation is apt to invite applications from other banks or financial institutions to penetrate the area through the acquisition of some kind of office or outlet, and likely it will weigh in the direction of favorable supervisory action in order to invigorate competition.

Similarly, if the services that a bank provides are not the best that are feasible, if its correspondent bank connections cannot provide convenient but nonpaternalistic supplements to the local bank's capacity (uninhibited by fear of loss of local customers to the correspondent), this situation, too, will delimit the scope of supervisory reactions to applications affecting the banking structure. Such circumstances might well prove to be an open invitation for

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some form of vertical combination, such as absorption of small banks by larger banks or by holding companies, where that is permissible. And such circumstances with respect to the quality and availability of banking services will supply some added weight on the side of supervisory approvals.

But just as the absence of full and vigorous competition in a community can invite actions to change its banking structure, so banker efforts to obtain undue market advantage or an undue concentration of financial power, by merger or other combination, can invite supervisory denials. Merger proposals that would make a relatively large bank still more dominant in its market area, reduce the number of effective competitors for the business of various classes of bank customers without substantial offsetting public benefits, or widen the gap between the competitive abilities of one or two major institutions and the remaining body of smaller banks - these are the kinds of proposals that are a clear challenge to the preservation of competition.

Such merger possibilities may appear very attractive from the self-interest viewpoint of the two combining banks, but if that attraction stems from such factors as sheer size, a sheltered geographical location, or any market advantage that has not been won in straightforward and uninhibited competition with other banks of roughly comparable capacities, then that private attraction has no counterpart in the public interest. A bank merger calculated to exploit such private advantage should have a hard time winning supervisory approval.

This kind of proposition often carries with it a juicy premium for the selling stockholders, and sometimes supervisors are told they should not deny them such a profitable opportunity. But not only is such a profit not a good reason for approval, it is sometimes a reflection of a sheltered market advantage that the buying bank is coveting, and as such may signal a reason for disapproval.

While I am interested in preserving competition and protecting the public interest, I am not opposed to mergers

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as such. There have been cases where mergers have improved competition, by combining noncompeting or ineffectively competing banks into institutions that contributed to a more balanced and vigorous competition within their banking markets. Merger proposals in the pursuit of private advantage that point in this direction warrant respectful attention; would-be mergers that overreach these bounds, however enthusiastically conceived for the greater glory of the proponents, are apt to be stillborn.

Vigorous competition among banks is what is sought - not as an end in itself, but for its fruits in the way of improved services to bank customers. Its purpose, like the avowed purpose of horse racing, is "improvement of the breed", and we generally subscribe to the belief that if one bank has to serve the public better than another does in order to get the business, it will try to do so. One of the best cases that can be made for the independent bank is the contribution it can make to healthy competition. The corresponding responsibility upon such an institution is to assume a vigorous competitive posture in all its activities.

Questions regarding too congenial interbank relations have become very touchy - witness the disputes which have been raging over alleged restrictive practices, with strong views being expressed by bankers and strong actions being taken by the Department of Justice. I do not know all the facts on which the actions are based, and, in the best American tradition, I assume innocence until guilt is proven. However, I hope no one permits the heat of the controversy to obscure the fundamental economic principle involved. The public has a right to expect competitive effort from all businessmen, and there is no reason why banks should be more protected than the members of any other industry from criticism or punishment for lack of competition within the bounds established by law, regulation, and ordinary banking prudence. To be blunt, "price-fixing" is just as adverse to the public interest when it occurs in banking as when it occurs, for example, in the electrical equipment industry. Frankly, I think all bankers interested in the long-run welfare of the industry should feel this way, and they should expect their supervisors to feel likewise and to act accordingly.

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I do not want my comments to be taken to imply that banks are always at fault in these matters, and that the various supervisory and regulatory agencies are always flawless. Supervisors have their imperfections, too. We are all human; the frailty that is inevitably a part of man's make-up cannot help but give rise to some mistakes. However, we humans in the federal bank supervising business receive an unhelpful assist in this respect from the organizational drawbacks to which we are subject. Three federal bank supervisory agencies in Washington, with overlapping jurisdictions, unclear legal guides to responsibility, and a variety of decision-making procedures, make coordination of actions difficult, consistency practically impossible to attain, and a race of laxity among them hard to avoid.

Every reasonable consideration leads me to conclude that the functioning of federal bank supervision would be incomparably better under a unified banking commission, such as I have suggested elsewhere. Such an organization would be more economical and more efficient. It could fairly be expected to be more clear-cut, balanced, and consistent in its decisions. Such a commission should be able to do a better job of establishing uniform ground rules that would aid - rather than impede - the progress of the entire banking industry and equalize competitive opportunities within it.

Incidentally, my proposal for a unification of federal functions in this field would strengthen - not jeopardize - the dual banking system. It would facilitate the build-up of each state's supervisory force, to the point where it could perform its functions without the assistance of a federal agency, without imposing heavy financial burdens on the supervised banks. This results from the fact that under my proposal examination costs of all insured banks - state and national - would be paid out of deposit insurance assessments.

However, when all is said and done, even the best designed regulatory superstructure cannot _by itself_ render banking a better industry. On the contrary, our kind of

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regulatory arrangements work best when they are tempering the workings of a banking system that is vigorously competitive, striving to progress as rapidly as the market permits, in the direction of expanded and improved services to a wider and wider range of customers, at the lowest practicable real cost. We need a high level of responsible competition in the banking industry as a spur to this kind of banking performance. Competition, in this context, is a servant of the public interest. Bankers, in their local operations, bankers through their regional and national spokesmen, and bankers in their role of citizens, must apply this principle with vigor and determination.

You may be noting, somewhat ruefully, that the results of all this might not be particularly enjoyable, at least for the managements of the banks involved. I agree. But we were warned about this a long time ago. Way back in the birth year of our Republic, 1776, a very wise man with the appropriate first name of Adam and the unremarkable last name of Smith gave us our first, and in some respects still our best, lesson in the valuable discomforts of competition. In his famous "Wealth of Nations", Adam Smith, the grandfather of modern economics, wrote, ". . . Good management . . . can never be universally established but in consequence of that free and universal competition which forces everybody to have recourse to it for the sake of self-defence." In plain English, the philosophy of free competitive enterprise allots to the businessman a life of perennial discomfort, always prodded by the needle of competition.

We who believe in this philosophy in general must suffer its stings in particular. I cannot assuage those stings, however much they may afflict you, but I can urge you to reconcile yourselves to them - even to rejoice in them - as the world's best substitute for rules and regulations, with the realization that they permit (in fact, compel) a banker's career to be more responsible, more challenging, and more productive.

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