BANKERS LIBERATION--EQUAL OPPORTUNITY IN THE MONEY MARKET

Remarks by Mr. Robert P. Mayo, President of the Federal Reserve Bank of Chicago, before the Iowa Bankers Association October 21, 1970

Liberation movements continue to be news. So I thought that I would be right in style if I talked with you today about "bankers lib."

As you know, the central theme for the liberation groups is that there are inequities in our economic system that require adjustment. Well, bankers have been concerned about inequities too and you've certainly let me know that. Let me hasten to add that I hope that you continue to communicate with me by telephone, letter or visit. Maybe that way I can discourage you from any urges you may have to picket or parade in front of the Fed.

A fairly wide range of problems have been suggested to me by bankers--problems from which they would like liberation. They all require attention and concern, but today I would like to talk about a problem area that has been of particular interest to most bankers in Iowa. How do rural banks compete effectively with their large city cousins? How can they achieve equal opportunity in the money markets? Are they discriminated against, forced to meet local demands with

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locally generated funds while the giants in Chicago, New York and on the West Coast pick up funds all over in the world?

Now, I may use the term rural or country banks but I am certain that you all recognize these complaints as coming from all sizes of banks. The smaller institutions argue that banks in the larger cities of the state have the advantage and these, in turn, raise the same concerns about their competitive relationship with still larger counterparts in the metropolitan areas.

I would be the first to admit that this concern about equal opportunity has not attracted many followers in the last few years. After all, even very small banks have discovered the Federal funds market. The income from such funds has been as high or higher than the return on credits to local customers.

But can you turn these flows into a two-way street, coming in as well as going out? I submit that as pressures ease in the money market, the chorus of voices representing concerns with access to financial markets will increase. The crescendo of concern is not likely to reach the volume of some of our "lib" groups, but it will be there nevertheless. And I think that it should be listened to.

What I would like to do today is to look at this problem with you. I would like to see if we can distinguish between complaints about real inequities that require adjustments and what may simply be disadvantages that reflect the failure to keep up with the stream of progress or to use efficiently the facilities available.

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These two sources of difficulties require different types of solutions or programs. The former may require some changes in our financial mechanism. The latter, however, may require essentially an educational effort or changes on the part of the banks themselves. Public agencies have a responsibility for providing a competitive environment that blocks the concentration of economic power. But neither regulation nor subsidy that preserves inefficient operations and therefore misallocates resources can be justified in the public interest.

Let us, therefore, take a look at what has been happening in Iowa and to Iowa banks. What are the implications for the existing structure of banking and the extent to which banks can take advantage of existing financial market facilities? Then perhaps we can suggest areas in which assistance is needed and what kind of assistance is likely to be helpful while preserving the purifying discipline of the market place.

First, a quick look at the Iowa economy. After all, banks--like all other businesses--have problems unique to their particular environment.

You are operating in a state whose total population, according to preliminary Bureau of Census estimates, has remained very stable between 1960 and 1970, growing only about 1.2 percent. However, nowhere is the trend toward urbanization more evident than in Iowa:

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-- Seventy-nine of Iowa's 99 counties lost population;

-- Eighteen of the twenty counties gaining population either had a city of at least 25,000 population or were adjacent to a county with a city of at least 25,000 in population;

-- Only two counties showing population gains were some distance from important urban centers.

Iowa manufacturing has also undergone significant changes. The rising productivity of Iowa manufacturing workers compares favorably with the nation as a whole. In 1958 the average Iowa worker produced just over $10,000 of manufactured goods; in 1967 he was producing $15,500 worth of goods. The number of manufacturing establishments has declined but the average size of plant has increased by 35 percent.

Food processing, nonelectrical machinery and electrical machinery still account for more than half of all manufacturing employment in the state. Food processing has not shown noticeable growth, but the two machinery producing sectors have grown rapidly. Thus, while agriculture and agriculture-related industry play an important role in Iowa's economy and will continue to be important for some time, other industries are catching up.

Iowa is seemingly destined to become progressively urbanized and industrialized and this trend will undoubtedly stimulate banking

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markets in urban centers. But rising prosperity throughout the state will support good markets elsewhere as well.

We see, consequently, the same developments that have changed the environment over the past decade and will continue to do so in the Seventies. These changes may appear to threaten the viability of smaller country banks. But they also generate new techniques for solving old problems and new opportunities for diversification and growth.

Let's take a look at one of those old problems--lending to agriculture. What assistance should or can be made available?

The predominant lending activity of Iowa banks is to agriculture. Farm loans account for 50 percent or more of total loans in over three-fifths of all the banks in the State. In nearly 90 percent of the banks, farm loans make up at least 20 percent of the loan portfolio.

Loans have increased at a much faster pace than deposits at rural banks in recent years, a divergence made possible by the low ratio of loans to deposits at most banks in earlier years. Expansion of bank lending by a relative shift from security investments to loans obviously cannot be sustained indefinitely. Individual banks began to reach "loaned-up" positions a decade or more ago and presently a large proportion have reached the point where further reductions in

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liquidity do not appear feasible or prudent, given present institutional arrangements. More than a fourth of the Iowa banks have loan-to-deposit ratios in excess of 65 percent--two-fifths have ratios in excess of 60 percent.

Also, many rural banks, because of their capital structure, have had difficulty in providing adequate credit service for their larger individual borrowers. Although most Iowa banks have boosted their capital accounts in recent years, there are still about 300 banks --or almost half the banks in the state--with capitalization under $200,000.

Projections of farm credit demands--both aggregate and individual borrowers--indicate substantial growth. This suggests that many more banks will find it difficult to supply from their own resources the same share of farm credit growth that they have provided in recent years. Generally, the banking system can employ various mechanisms and devices to obtain outside sources of funds. However, in many rural areas and for many small banks these mechanisms are unavailable or inadequate. Branch and group banking are prohibited in many areas; correspondent banks have not provided a sufficient volume of funds; discounting at Federal Intermediate Credit Banks has been negligible; liability management has been fairly difficult for small rural banks and secondary markets for their loans are virtually nonexistent.

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Recognizing these problems the Board of Governors of the Federal Reserve System last spring established a special committee within the system to investigate agricultural credit problems in capital deficit areas and possibilities for their amelioration through improvements in marketability of rural bank paper. The recommendations of this committee are expected in mid-1971.

But this is only one channel through which country banks may achieve "equal opportunity" with their city counterparts. It is not the first. It will not be the last.

Real progress stemming from Federal Reserve efforts to improve markets, however, can only be made if the banks respond. They must make effective use of innovations and be willing to adjust their services to the changes in demand for them. If they do, it will be healthy both for the public and the banks.

In a nutshell, continued viability of the rural banks will depend on (1) their capacity to recognize changing demands for their services, and (2) their ability to turn the benefits of technology to the advantage of their customers and, therefore, themselves. The latter entails, of course, access to money markets and information about them. Your city correspondents can help you here and I encourage you to use their facilities.

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Trends in these directions have already begun. As the nation has shrunk in terms of communications, and as the inexorable pressure of rising costs has forced economies of scale in business--especially in agriculture--a good many small banks have diversified their lending and have found ways to participate in either national or regional money markets so as to better synchronize their sources and uses of funds.

No longer need the local bank in the heartland of America be a specialized agricultural lender, with all the problems--with respect to both amounts and timing--of matching locally generated funds with local demands. Long-established patterns change slowly, but evidence on the distribution of loans over the past decade demonstrates that flexibility has increased. Iowa banks, both large and small, while still holding a greater proportion of their assets in farm loans than banks in any other state in this Federal Reserve District, have reduced that share. The difference is reflected in higher credits to commerce, industry, and consumers.

Another significant development of the last decade has been the growing participation of small banks in the national money market--partly direct and partly through correspondents. The most important access route has been through the Federal funds market. Through this facility smaller banks were able not only to put funds to work at good returns but, at the same time, to maintain a much higher degree of liquidity than their overall loan-deposit relationships might imply. At last count our records show that about two-thirds of all member banks in

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this District participate in the Federal funds market--at least occasionally. The participation ratio is least, as might be expected, among the smallest banks. But the fact that even a few of the banks with deposits less than 5 million dollars do take advantage of this facility suggests that the potential is there for many others, too.

The Federal funds market is just one example of how ability to tap the money market can provide a means of liberating the small bank from the constraints of a small and undiversified local market for its services. And it is obvious that small banks have a heavy stake in the developments of other market facilities--such as secondary markets in locally generated credit instruments--that will free them further from the rigidities inherent in narrow markets and concentrations in credits to borrowers with similar characteristics.

But while a pipeline to the money market may provide access to participation in the good life, it cannot provide real liberation if it serves either to divert funds away from the legitimate needs of the local community or, contrariwise, to absorb capital that would yield higher real returns elsewhere.

It is a fact that the vast majority of smaller banks that participated in the Federal funds market in the past two years have used it only as an outlet for funds, sometimes in significant amounts relative to their size. Perhaps these have been banks in "surplus" areas--that is, where funds generated through personal, business or public deposits

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have exceeded local credit needs. But to a large extent they represent channeling of funds to the customers of the larger banks that are the purchasers. At the money market rate levels of the past two years, the income from such use of funds may have been as high or higher than the return on credits to local customers.

Whether some of these funds found their way back to rural credit deficit areas, it is impossible to say. But to do the job of channeling flows of credit to their optimum uses, market facilities must provide a two-way street. There is little evidence that the Federal funds market has been a significant source of funds to rural banks generally.

I would not want these remarks to be construed as advocating borrowing short and lending long. Obviously the short-term money market cannot solve all the problems of handling today's agricultural credit needs. But greater access to it could perhaps improve flexibility.

For most of the smaller banks, the direct link to the money market is through correspondent banks, but the purchase of Fed funds is only one of the ever-widening services they offer. Very little information is available about the volume of longer-term credit flowing from city correspondents to country banks, but what evidence there is suggests that it is much less than might be expected and often quite costly.

At the same time, both statements from correspondents and the favorable experience of some small banks suggest that customer banks

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who aggressively seek funds from this source find it, provided they have a record of good management and a sound portfolio. The major complaint that we hear is that many small banks don't keep their houses well enough in order and can't provide enough information on credits to allow the correspondents to act in timely fashion. And, to repeat another point just made, many small banks just don't pick up their phones and seek out the services that may be available to them.

But it is also obvious that country banks would be in better position to demand services from correspondents if there were more direct links between credit surplus and credit deficit areas--markets oriented to the kinds of credit instruments generated in rural areas. Since these are typically obligations of people known only locally, some kind of insurance undoubtedly would be required. Such a system, moreover, would be far more consistent with the market's ability to allocate resources impersonally and efficiently than that which could possibly emerge from subsidized or other artificial efforts to equate the odds between small and large banks in their access to funds.

Small banks will have to depend on large banks or grow enough by themselves to supply the wider services the public increasingly demands. In the past, rural banks have been more insulated from cyclical swings in both monetary policy and credit demands. But as market areas enlarge, via technology, this insulation will diminish. And, more immediately, as pressures ease in money market, the easy returns from Fed funds sales will be less reliable as a steady source of earnings. Therefore, it would be wise to give first priority to local credit demands.

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As regulators, we must not underestimate problems of the small bank, but neither can we justify subsidizing obsolescence, and certainly our judgment is not adequate to substitute for the market's function. The entire history of Federal efforts to solve the farm problem serves as a warning against laying the first stone of a potential pyramid of controls in the name of helping deserving small enterprise.

Our role, as I see it, is to help remove the obstacles that obstruct the free and competitive working of the market--for these are the real causes of any disadvantage the rural banker suffers--not to substitute decisions that may produce contrary results. Only in this way can we bring real equality of opportunity to all financial institutions and a fair deal to the public.

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