THE CHALLENGE FOR BANKING IN THE SEVENTIES

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One of the most persistent and controversial questions in American banking concerns the continued existence and role of the smaller, locally owned and controlled, unit bank. Depending on the definition one chooses to adopt, there are from 2,500 to over 6,000 such banks for the nation as a whole. Thus, this is a matter of vital concern to bankers, the public, and bank supervisory officials alike.

Those most directly affected among bankers, are, of course, the officers, employees, and stockholders who are associated with the smaller banks. Naturally, their lives are intimately affected by the future performance of such institutions. Their concern has found expression in the organization of numerous state, regional, and national associations dedicated to the preservation of "independent banking." At the same time, other bankers with more than a passing interest in the matter are the officials of big-city banks who would like to expand their operations, either by branching or the establishment of a multiple-bank holding company, but are currently prevented from doing so by state restrictions. Bank supervisory officials, in turn, have a somewhat different interest in the matter. They are, first of all concerned with bank solvency as it affects the stability of the payments mechanism. In addition, their decisions to approve or deny transactions which would consolidate or eliminate small banks often depend heavily on evidence regarding the prospects of such banks for rendering adequate service in the future.

All of these groups, though their interests differ and, in some cases, conflict, benefit from objective knowledge of the situation as it exists. Public discussion of the merits and shortcomings of the uniquely American phenomenon of the small unit bank has long been an arena for the exchange of charges and propaganda by acknowledged self-interest groups. And on some occasions the truth or falseness of the propositions offered in this arena seems to have been considered secondary to their effectiveness in convincing the public to support one point of view or another. My objective this afternoon will be to try to lay bare some of the issues. I make no claim to ultimate answers, but I think I can help to outline the existing evidence in an objective fashion.

Definitions

A logical starting point for such a discussion is with a definition of a "small bank." Although any definition is necessarily arbitrary, there is much to be said for designating as a "small bank" every commercial bank with $5 million or less in deposits. Such a definition seems to encompass most banks whose size may present particular problems. It also conforms to a deposit-size category for which published data are available.

My basic task is to discuss in general terms the "viability" of small banks. Here the term "viability" is not used in the narrow sense of ability to survive--though that is certainly a major ingredient of "viability." I am thinking of the term more in the broader sense of a bank's current profitability and adequacy of service, and the likelihood that it will be able to continue rendering such service profitably a decade or longer in the future.

Some Background Information

The problems of small banks are comprehensible only within the framework of the peculiar characteristics of American banking and banking regulation. The United States' unit banking system--comprises, more than 13,000 separately incorporated banking firms, each with its own board of directors, place of business, and chief executive officer--is unique in all the world. In no other country is there such a profusion of banks. This has been abetted by an historic aversion to concentrated financial power--and the associated reluctance in many states to embrace branch banking. It has been encouraged further by a permissive entry policy engendered by competition between federal and state chartering authorities within the framework of our similarly unique dual system of bank regulation. The seeds of American enterprise indeed found fertile ground in the field of banking.

The establishment of new banks took on a feverish pace in the early decades of this century, fed by continued population growth, a broadly based prosperity, and the unprecedented demands generated by World War I. In 1921, the number of commercial banks in the United States reached an unheard-of level in excess of 30,000. It soon became clear that the banking system was far overexpanded. Although the 1920s were a generally prosperous decade, the return to prewar levels of the demand for foodstuffs and raw materials produced a virtual agricultural depression that lasted until World War II. The consequences for rural banks were disastrous. In almost every year between 1921 and 1929 more than 500 banks failed; the total for the decade was almost 6,000.

With the advent of the depression the decade-long ripple of bank failures reached the proportions of a tidal wave; in the years 1930 through 1933, 8,000 banks failed. After the introduction of federal deposit insurance in 1933, which removed the major cause of bank runs, and the institution of tighter regulation and more restrictive entry policies, bank failures slowed to an annoying trickle. Consolidations and voluntary liquidations combined to reduce the number of banks to approximately the present level by the early 1940s. Since then, there has been no apparent trend in either direction, only fluctuations between about 13,400 and 14,300. Since 1954, the number has not exceeded 14,000 or fallen below 13,000.

The overwhelming number of individual banks tends to exaggerate the degree to which banking in the United States is a diffused, decentralized industry. However, as Federal Reserve Governor George W. Mitchell has noted on several occasions, looking only at the number of banks can be misleading. As one views the distribution of banking resources, the picture is quite different. Three-quarters of the commercial banks in the United States--some 10,000 of them--are unit banks. However, they accounted for less than one-third of the deposits and served only one-third of the banking customers. At the other end of the spectrum, the largest 1 percent of banks accounted for more than half of total deposits. The 20 largest banks alone accounted for nearly one-third of all commercial bank deposits. Indeed, it is as though the United States possessed two banking systems: one, on the European plan, composed of a relatively few giant banks with vast international operations and extensive branching systems; the other, with five-sixths of the number of banks but only one-sixth percent of the total deposits, servicing the some 7,000 one-bank communities and other small towns and rural areas throughout the country.

Much the same picture is given by an examination of the distribution of banking offices. On December 31, 1969, there were, in addition to the 13,000 odd head offices of commercial banks, more than 20,000 branches and limited-service offices at which some types of banking business could be transacted. Most of these branches were established since World War II, and especially since 1950. As late as December 31 of that year, there were only about 5,000 branches of commercial banks in the United States. Between then and the end of 1969 this increased by well over 15,000, or more than threefold. Although some of this increase in the number of banking offices resulted from the conversion of independent banks to branches following mergers, the overwhelming majority--on the order of 80 percent--were established de novo. But, primarily because of the differing laws governing branching in the several states, this growth was concentrated in certain areas. Although the percentage of banks operating one or more branches has been steadily increasing, unit banks still far outnumber branch banks. As of December 31, 1969, there were almost 4,000 banks, or 28 percent, operating at least one branch, as opposed to about 1 percent in 1900 and 10 percent in 1950. More than 10,000 of the nation's banks remain unit banks. Most, though not all, of the 7,000 insured commercial banks with less than $5 million in deposits--our arbitrarily defined small banks are among these 10,000.

Although relatively modest in terms of national totals, these banks at the lower end of the size scale are still the sole source of banking services for an absolutely large and, even in relative terms, significant fraction of the American population. Largely for this reason, their performance in providing these services is a matter of broad concern with important implications for public policy.

Current Profitability of Small Banks

Undoubtedly, the simplest argument one could make for the proposition that small banks are viable is that they exist. But mere existence does not indicate whether a bank is doing a good job relative to some objective standard of performance that is both technologically feasible and economically attainable. Both continued existence and observed profitability can in many cases be evidence of a protected market position rather than "viability." However, there are ways of determining whether observed profitability is due primarily to desirable economic performance or to the absence of competition. Therefore, it may be of interest to look at what the data show regarding the profitability of small banks.

National Operating Ratio Data

There is some question as to just which of several alternative measures of profitability is most appropriate for assessing the success of banks. Should we use net current operating earnings, net income before taxes or net income after tax is in conjunction with capital or total assets? Because capital ratios are subject to supervisory influences and are likely for that reason to vary greatly between banks with little relation to basic economic factors, some economists prefer to measure profitability with respect to total assets. However, it seems clear that what bank stockholders are more interested in, and what bears most directly on decisions to enter the industry, is the return on equity. Moreover, the return on total assets is essentially irrelevant as a measure of performance from a broad social standpoint. Just as a wholesale operation usually operates with a lower margin than a retail operation, banks dealing primarily in large, low-risk loans can be expected to have lower returns on assets than banks dealing largely in small loans with relatively high risks of default. There would seem to be no more reason for calling the latter more efficient than there would be to say retailers are more efficient than wholesalers because their earnings are greater relative to their volume of business. Hence, profitability is better measured relative to total capital accounts.

Another problem relates to the choice among net current operating earnings, net income before related taxes, and net income after related taxes as measures of profitability. Because net current earnings are dependent very largely on performance during the current period, while the net income figures include security transactions and may reflect decisions based primarily on tax considerations, the former has sometimes been held to constitute a less objectionable indicator of performance. But portfolio management, as reflected in losses or profits on sales of securities, is also an important element of banking performance. Especially if one considers average profitability over an extended period of time, as will be done below, the year-to-year distortions from tax-motivated transactions should tend to wash out. In this case, the net income figures would be expected to give the most comprehensive picture of bank profitability.

Finally, there is the choice between net income before related taxes and net income after such taxes (primarily the federal corporate income tax). In a competitive market, with investors free to make their decisions on the basis of all economic considerations, it is the net income after taxes that would tend to be equalized. Thus, the advantage given to small banks by the lower tax rate applicable to the first $25,000 of net income would be neutralized, in equilibrium, by the entry of additional resources into the market. For all of these reasons, the ratio of net income after taxes to total capital accounts is chosen as the best single measure of bank profitability. Net current operating earnings and net income before related taxes will be presented as supplementary data.

Data compiled by the Federal Deposit Insurance Corporation for all insured commercial banks indicate a marked relationship between bank size and profitability. Moreover, this relationship is independent of which measure of profits is chosen.

The average earnings ratios of the banks in the first three size classes (less than $1 million, $1 to 2, and $2 to 5 million in deposits), which constitute "small banks" under the definition mentioned earlier, are lower than those of the banks in any other size

Bank Profitability by Deposit Size Class, 1968

	Deposit Size (millions of dollars)								
	Less than 1	1 to 2	2 to 5	5 to 10	10 to 25	25 to 50	50 to 100	100 to 500	500 or more
	(percent of total capital accounts)								
Net current operating earnings	9.95	12.39	13.95	15.92	17.00	17.73	17.07	18.18	17.67
Net income before related taxes	8.62	10.52	11.28	12.73	13.51	13.90	13.57	14.59	12.96
Net income after taxes	6.89	8.23	8.50	9.48	9.96	10.17	10.31	10.58	9.35

class. The earnings ratios increase in each successive group through the \$25-\$50 million deposit class. They decline slightly for the \$50-\$100 million class, increase again in the \$100-\$500 million class, and then decline again in the \$500 million and over class. The earnings ratio of the most profitable size class of banks, the \$100-\$500 million deposit, size class, was about 1.6 times the ratio for the least profitable class--the less than \$1 million deposit-size group--and about 1.2 times the ratio for the most profitable of the "small bank" size classes--the \$2-\$5 million deposit-size group.

These are sizable differences. To the extent that they can be taken at face value, they indicate a marked inferiority in earning power of banks in the smallest size categories.

Seventh District Member Banks

Operating ratio data for member banks of the Seventh Federal Reserve District show the same pattern as the national data for all insured commercial banks. In each year from 1961 through 1969, banks in the two lowest deposit-size classes had average ratios of net income after taxes to capital accounts smaller than those of banks in larger size classes. The fact that this situation prevailed in each of the last nine years suggests that there is very little chance that it could be the result of special factors operative in a particular year.

The differential in the ratio of after-tax income to capital between the largest and smallest deposit-size class ranges from 2.0 to 4.6 percentage points over the nine-year period; in relative terms, the average rate of return of the largest group ranges from 1.27 to 1.66 times that of the smallest size group. Although the trend is not

Ratios of Net Income After Taxes to Capital Accounts

Year	Under 2.5	2.5 -5	Under (5)	5 -15	5 (-10)	15 -25	10 (-25)	15 -50	25 -50	50 (-100)	Over 50	100 (-500)	Over (500)
	Deposit-Size Groups (in millions of dollars)												
1961	7.3	8.3		9.3				(10.8)			11.9		
1962	7.4	8.2		9.1				(8.8)			9.4		
1963	6.9	8.0		8.1		8.6			8.3		9.2		
1964	7.0	8.0		8.7		9.0			8.8		9.1		
1965	7.5	8.5		8.5		9.2			9.5		9.6		
1966	8.5	8.5		9.3		9.6			10.2		9.4		
1967	6.5	8.9		9.5		10.3			11.1		10.8		
1968	7.2	8.6		9.0		10.6			10.6		11.3		
1969			(8.7)		(9.9)		(10.4)		10.7	(10.8)		(10.7)	(10.7)

very clear, it looks as if the differential may have widened in the last three years, although a major revision of the class intervals in 1969 obscures the change during that year. Whether this is a lasting development remains to be seen; but it constitutes a marked departure from the behavior of the differential between 1954 and 1965, when it ranged between 2.0 and 2.6 percentage points. Changes in the populations of the several size classes attributable to growth and redefinitions of the class boundaries make impossible any definite conclusion about changes through time.

The data do indicate, therefore, that small banks have poorer earnings records. It is of interest, however, to determine whether this apparent disadvantage is simply a matter of accounting or, if real, whether it reflects a conservative assets policy, a less than optimal pricing policy, or high costs.

There are several possible sources of bias in the reported earnings data based on the arbitrariness of accounting procedures. It has often been suggested, for example, that the owner-managers of small banks tend to pay themselves "relatively modest salaries while building up their equity in the banks through retained earnings." In this way they may be able to increase their overall after-tax income. In a strict economic sense, the return on capital would be exaggerated and salary expense underestimated. However, the existence of such behavior would only strengthen the conclusions reached above, in that a more correct reporting of salary expense would make even more pronounced the differentials in earnings ratios. Others have suggested the possibility of a systematic, size-related bias in reporting profits that runs in the opposite direction--i.e., that closely held small firms may pay their owner-managers excessively high salaries to avoid double taxation of dividends. In this case, the profits of small banks would be understated.

Evidence on the salaries paid by banks of different asset size does not support the hypothesis that small-bank owner-officers take much of their profit in the form of high salaries. A 1967 survey indicates that the median officer's salary paid by banks with more than $500 million in assets ranged from 14 percent to 33 percent greater than that paid by banks with assets of less than $100 million, depending on the age group of the officers. To be sure, officers' salaries--and, for that matter, total salary expense--constitute a smaller share of total operating expenses for large than for small banks. But this is primarily a matter of a lower ratio of officers to employees at larger banks. So it appears that the lower rates of return on equity earned by small banks are real.

Remarkably enough, these low earnings ratios do not result from any obvious inefficiency in utilization of small bank assets. Although small banks tend to hold from 5 to 15 percent less of their assets in the form of loans than the largest banks--because of conservatism, liquidity needs, weak local loan demand, or deliberate restriction of credit to maintain its price--this alone would account for only a very small difference in their rate of return. Nor is the difference to be found in differences in gross yields on assets. Rather than displaying any persistent tendency to be consistently either higher or lower than that of large banks, the average return on loans of small banks doesn't seem to change much. Thus, when interest rates are high or rising, the average rate of return on loans and on total assets of large banks rises above that of small banks. The opposite seems to be true when rates are low or falling.

Similarly, the ratio of total expenses to total operating revenue shows no consistent variation with size. In 1969, Seventh District member banks with deposits under $5 million had an average expense/income ratio of 78.26 percent, while those with deposits over $500 million had an average ratio of 78.72 percent.

With no systematic differences in either gross yields on assets or the ratio of expenses to revenue, the lower earnings of small banks on capital can, as a matter of arithmetic, be attributed to only one factor--a higher ratio of total capital accounts to assets. The data confirm that this is the case. In 1968,Seventh District member banks with under $2.5 million in deposits had an average ratio of total capital accounts to assets of 11.3 percent, about 1.7 times as great as that for banks with over $50 million in assets. Accounting changes in 1969 destroyed comparability with the earlier figures, but the ratio of total capital accounts and reserves--the base on which return is now measured --to total assets remains much higher for small banks. Thus, so far as current profitability is concerned, the differences between large and small banks are primarily a consequence of the much higher capitalization ratios of small banks.

The reasons for these differences in capitalization ratios are not entirely clear. Occupancy expense ratios do not suggest any major economies due to indivisibility of bank premises. On the other hand, the great variability in loan loss experience among small banks suggests that they may be subject to considerably more risk than large banks with a larger number of loans on their books. Small banks may also be subject to greater risks from deposit fluctuations, although the most recent evidence suggests this depends heavily on the observation period one uses in measuring deposit changes. Finally, differences in capitalization ratios may be caused, in part, by regulatory pressures, although there is some evidence that banks have succeeded in substituting deposit insurance for capital as protection for depositors. Whatever the causes, however, it is clear that small banks do suffer a major earnings disadvantage.

Recent Evidence on Economies of Scale

Although the operating ratios data do not appear to indicate that costs decline as a bank grows other studies utilizing measures of banking output and costs suggest little grounds for doubting that there are economies of scale in the production of commercial banking services.

To be sure, the results of some of the earlier of these studies are subject to doubt because of their uncritical use of operating ratio data. By measuring size or output by the dollar volume of deposits or earning assets, they attribute to the economies of large size some cost savings that are actually the result of larger average size of transactions. Consequently, they cannot be interpreted as showing that large banks could provide the mix of services small banks are called on to provide at a lower cost. Later studies, however, employing as measures of output such physical measures as the number of accounts and account activity, tend to confirm the earlier findings of economies of scale in banking. What is probably the most sophisticated of these studies, published in 1968 as a Research Report by the Federal Reserve Bank of Boston, concludes that,

> If a typical commercial bank were to expand all its activities (functions or products) within its existing facilities by 10 percent, total cost would rise by 9.3 percent . . ..

In other words, costs would increase by less than output, and unit costs would decline. The quality of the data and the careful methodology of the more recent studies leave little grounds for doubt that there are economies of scale in production of commercial banking services.

It does not follow, however, that small banks should disappear, either through merger into larger banking organizations or through competitive extinction. Most small banks serve markets that are themselves both small and geographically separated from each other. So long as we confine our attention to unit banks, therefore, there is no way to increase the size of such banks to improve efficiency. They may, in fact, be optimal size for the markets that they now serve.

But even assuming that such banks could be acquired by large banks and operated as branches, it is not clear that it would in all cases be economical to do so. In the first place, the costs of operating banking facilities at more than one location often tend to offset the economies of larger size. Because of the difficulties of obtaining appropriate data for individual branches, this question cannot be answered definitively. Yet, preliminary evidence suggests that any cost advantages obtainable by operating a banking office of a given size as a branch of a larger bank, rather than as a unit bank, are modest--and perhaps marginal in many cases.

Finally, the evidence on economies of scale fails to condemn all small unit banks because of the great variation in performance of banks within a given size class. The observation of a systematic tendency for small banks to have higher unit costs than large banks does not deny the fact that the many efficient small banks are more efficient than the average large bank. There will always be a place for the well-run, efficient, small bank. The very nature of an average, however, implies that these banks displaying exceptionally good performance are offset by a roughly equal number of small banks whose performance is poor. Except insofar as their owners are willing to endure less-than-competitive returns in exchange for the privilege and prestige of continuing in the banking business, the future of such institutions is bleak.

Aside from this fringe of small banks of undetermined number that are presently marginal and likely to become submarginal in the not-too-distant future, the continued existence of many small banks will depend on how well they are able to cope with expected increases in what Mr. Howard Crosse, formerly of the Federal Reserve Bank of New York, has called "prospective costs." These are the levels of costs which the bank may reasonably expect to incur in the near future, as opposed to its current operating costs. In many cases, because of imperfections in the labor market or other special conditions, the accounting costs banks experience currently are far lower than their "prospective costs." A common example is the experienced and trusted employee who, because of his attachment to the community and the satisfactions of his job, has been willing to accept a salary lower than a man with comparable qualifications could earn elsewhere, but who is nearing retirement age.

It is very unlikely that the man in question can be replaced with a younger man except at a considerably higher pay scale. The salary differential between large and small banks is much less for younger officers more willing and able to seek alternative employment. To use a term from a somewhat different context, the replacement cost for such an employee is sharply higher than his original or historical cost. Failure to take account of such a factor in planning for the future is the equivalent of living off one's capital. The particular example used to illustrate the problem of increasing "prospective costs" is familiar to bankers in the guise of the "management succession problem."

A potentially more dangerous threat to the continued satisfactory functioning of small banks is the development of new banking services and technology that require both specialization of labor and large, indivisible pieces of mechanical or electronic equipment. It is argued that, because the minimum size of bank able to take full advantage of such cost-reducing and service-expanding innovations is quite large relative to the banks under discussion here, these banks will eventually be forced to combine, in one way or another, into larger banking organizations. To state this view is not to demonstrate its validity.

The fact that only large banks find it feasible to operate their own computers is not equivalent to a demonstration that small banks cannot enjoy the benefits of a computer. Already, many smaller banks purchase computer services from independent data processing firms on a time-sharing basis; some purchase such services from their large-city correspondents. Finally, many banks have found entry into the computer age to be anything but an unmixed blessing. Oftentimes, predicted cost reductions have not been realized or have been realized years later than expected. More recently, competition in the provision of computer services on a time-sharing basis has developed to the point where few banks are able to report a profit on this type of business. Despite these reservations, however, there remains a presumption, shared by many within the banking community and elsewhere, that there are indeed benefits in efficiency and improved service to be realized by combining existing small banks into units large enough to take full advantage of a continually evolving computer technology.

Serving the Community

Of all the questions having to do with the present and future role of small unit banks, none is more important or more difficult to answer than that of how well they have served the "convenience and needs" of their communities. Bankers are fond of expounding on the friendly, personal service rendered by small, locally owned banks and citing evidence that such banks tend to make more unsecured loans than the cold, businesslike branches of big city banks. Advocates of bigger banks and expanded branching are likely to retort that hard financial facts are a better basis for allocating society's scarce capital than the personal likes and dislikes of a country bank president and to cite other figures indicating that large banks, consistently place a larger proportion of their assets in loans, which contribute directly to community developments, than do small unit banks.

There have been a number of studies designed to "throw some light" on this question as to how well banks of various sizes meet the needs of their communities. For example, a recent survey of more than 2,000 banks in the Seventh District indicated that only three of 17 non-credit services offered primarily to consumers, were offered by a larger percentage of small banks than of large banks. These included one-statement banking, insurance agency, and automatic customer bill payment services. It was hardly surprising, moreover, to learn that the most dramatic differences were in trust services, foreign banking services, and in-plant banking. Similarly, of 19 non-credit services, offered primarily to businesses, only one--insurance agency services--was offered with greater relative frequency by small banks. All the others--including credit information, lock boxes, bank statement reconciliation, payroll accounting, business income/expense record keeping, equipment leasing, managerial services, and freight traffic services--were offered with greater relative frequency by large banks.

It is obvious that what appears to be a marked superiority on the part of large banks in rendering services is simply a reflection of the differences in demand between urban and rural areas. Even if there is a latent demand in the areas served by small banks for such services as portfolio management, securities registration, freight payment, and trust services, it is clear that this demand could not be very great. That being the case, it is doubtful that a large bank acquiring such a small bank and operating it as a branch would find it economic to offer all these services at the branch office. In many cases--as has become apparent to us in the course of processing applications for mergers and holding company acquisitions in the Seventh District--a promise to provide, for example, trust services at an office where they were previously unavailable often means no more than that a customer inquiring about such services will be referred to the trust officer at the bank's head office. This, obviously, adds nothing to what a unit bank can do by referring customers to its correspondent.

What appears to come through from these data is that the provision of services depends largely on the banker's capacity to recognize the demand for services in his area and his ability to turn the benefits of technology to his own and his customers' advantage.

To some of your customers, in particular the Iowa farmer, the ability to obtain credit when and in the quantities he needs it, will be of much more direct interest and immediacy than the variety, quality, or even price of services. In the years immediately following World War II, this did not constitute a problem. The great liquidity built up in preceding years enabled the rural banks to meet demands for agricultural credit without difficulty. As loan-deposit ratios and the average size of farms have continued to grow, however, the situation has changed; rural banks are reaching the limits of their lending capacity in two distinct but related senses.

First of all, most rural banks no longer have the excess liquidity they did 20 years ago. Loans have increased at a much faster pace than deposits.

A further complication faced by rural banks in servicing the credit needs of their farm customers is the continuing rise in the average size of loan requests. After doubling between 1956 and 1966, the rate of increase in the average size of farm loans has shown no tendency to taper off in more recent years. This means that a continually growing proportion of farm loans approach the legal lending limits of the farmers' local banks.

These developments, plus projections of substantial growth in farm credit demands, suggest that many small banks will find it difficult to meet, from their own resources, the credit needs of their communities. Appropriately, attention has been directed toward devising new means to channel funds to rural banks--including the encouragement of banks to discount farm loans at Federal Intermediate Credit Banks, expanded seasonal borrowing privileges at the Federal Reserve discount window, and Government guarantees for some new type of debt instrument to be issued by rural banks to make the development of secondary markets feasible.

But as useful as these types of measures may be, banks should not rely on them to rationalize their own inaction in other ways. As I argued last October in Des Moines, small banks must respond if we hope to improve these credit flows. The correspondent bank system, for example, is very much alive. Through aggressive and imaginative use by both small and large banks it can provide an even more efficient channel for the flow of funds between capital surplus and deficit areas.

I firmly believe that the viability of the small bank depends largely on the willingness and ability of bank management to grasp the opportunities available. We can review, discuss, and evaluate the most sophisticated of economic studies but would still come to the conclusion that these are poor substitutes for the test of the market place. The only conclusive proof of the continued usefulness of the small bank is their customers' demonstrated loyalty in the face of convenient alternative sources of banking services.

We can and should be striving to remove the obstacles that obstruct the free workings of the market. But we can not as regulatory and supervisory authorities substitute our decisions for those of the banks. Nor should we be asked to do so.

These are difficult issues. I do not pretend to know how they can best be resolved. My intention in raising them has been to go to the roots of what, in my view, are serious questions affecting the future of the banking system. And with these words, I pass this hot potato back to you.