THE CHALLENGE FOR THE SMALLER BANK: ITS ROLE IN AN INCREASINGLY COMPETITIVE WORLD

Remarks of Mr. Robert P. Mayo
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at the Twenty-ninth Correspondent Banking Clinic
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An article in the Wall Street Journal late last year reported on a convention of motor home manufacturers, who, as you know, had been hit hard by tight money and local fuel shortages earlier in the year and then dealt a crushing blow by the Arab oil embargo. Funereal humor is said to have pervaded the convention. One speaker, while discussing the effect of the fuel shortage on the motor home industry, declared that motor homes averaged 18 miles to the gallon--ten on the road and eight in town--and another, frankly acknowledging his expectation that a number of the manufacturers would not be around for next year's convention, took the occasion to say good-bye. To a lesser degree, and with somewhat less urgency and alarm, a similar sense of impending doom has pervaded bankers' conventions in recent years whenever the subject of the future of smaller banks has come up. Indeed, this has been the central concern of the associations of smaller bankers for over 40 years. For those who share this concern I have today some bad news and some good news, and I will follow that with a prediction--or, to play it safe, a projection--regarding what I believe is actually going to happen.

First, the bad news. It requires little more than an honest glance to ascertain that success on the part of movements to liberalize the branching laws in Illinois and elsewhere do not bode well for the continued existence of the fragmented system of unit banks that currently exists

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in the United States. All the evidence suggests otherwise. Since shortly after the end of World War II the total number of commercial banks has remained practically unchanged at 14,000. But the total number of banking offices has increased from about 18,000 to over 40,000. In relation to this growth, independently chartered banks have played a small role in the expansion of banking offices over the period. Between the end of 1947 and the end of 1973 the number of unit banks in the United States declined from over 13,000 to under 10,000, while the number of branches in the United States increased from 4,000 to more than 26,000--a sixfold increase.

Part of these diverse trends reflects the fact that in states permitting branching, the expansion of banking facilities resulting primarily from the growth of population and the increase in economic activity took the form of new branches--not new unit banks. Part of it reflects the greater expansion of banking facilities in branching states than in unit banking states. For example, states permitting branching experienced a net decrease of about 1,600 in the number of banks between 1947 and 1973; unit banking states experienced a gain of 1,600. However, the total number of banking offices, including both banks and branches, increased from less than 13,000 to more than 32,000 in branching states, an increase of about 150 percent, while in unit banking states the increase was only from 5,600 to 8,300, or about 50 percent.

In states that have recently liberalized their branching laws, the evidence is even more dramatic. In New York, where the Omnibus Banking Act of 1960 provided for a gradual broadening of the area within which branching is allowed with the goal of statewide branching by 1976, there was a decline in the number of banks from 400 to 300 between 1960 and 1973 while the number of branches more than doubled (1400 to 2900). Virginia's transition

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from limited branching to statewide branching by merger in 1962 saw a trebling in the number of branches. New Jersey's experience has also been striking. A law passed in 1968 provided for statewide holding companies and divided the state into three districts for purposes of branching. By the end of 1973 the number of banks had declined slightly while the number of branches rose by more than 50 percent.

If one takes account of multi-bank holding company acquisitions and new bank formations, the relative position of genuinely independent unit banks has deteriorated even more. Nationwide, the number of multi-bank holding companies increased from 50 in 1957, one year after the Bank Holding Company Act was enacted, to 210 in 1973 and the number of banks under their control from 417 to 1,457. In New Jersey and Virginia, which previously had prohibited multi-bank holding companies, the percentages of the total number of banks in these states under control of such companies are now 19 and 30, respectively. Multi-bank holding companies are just getting underway in Michigan.

Nevertheless, as of June 30, 1972, there were still 3,756 banks with under $5 million in deposits in the United States and 3,303 banks with between $5 million and $10 million. If the small bank is gradually disappearing, reports that it is dead and buried are--to borrow a phrase from Mark Twain--"greatly exaggerated." Nevertheless, flocks of passenger pigeons blackened the sky a few decades before that ill-fated bird became extinct, and before taking smaller banks off the endangered species list we need to look beyond their present numbers.

There appear, however, to be some fundamental economic forces responsible for the recent decline in the relative numbers of smaller independent banks. Furthermore, there is no reason to believe that these forces

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have run their course. The immediate impact of these forces may be read in the bottom line figures on the income and dividend reports. The average return on equity capital of Seventh District member banks with deposits under $5 million has been consistently below that of banks in larger size categories over the past decade and a half. With few exceptions, this has also been true of banks in the under $10 million deposit size class. This is primarily due to higher capitalization ratios rather than higher expenses relative to revenue or a lower return relative to total assets. On the other hand, it does not appear to reflect any systematic understatement of earnings that might occur if, for tax purposes, owner-managers of small banks took some economic profits in the form of fancy salaries. It appears, instead, to be a real disadvantage suffered by smaller banks because of size and risk characteristics that may be difficult to overcome. Moreover, there appears to be some tendency for the earnings differential to increase in recent years, although this may simply reflect the strong cyclical pattern in earnings of large banks.

Several economic forces with potentially serious adverse effects on the prospects of smaller banks are either currently in operation or becoming visible on the horizon. One of these is the continuing development of new ways of doing business and new technologies that make it less important for banks to be located as close to their customers, thus eroding some of the protection currently afforded to many small banks by entry and branching restrictions. Examples abound, but the most important include: banking by mail; the growing use of bank credit cards and other forms of preauthorized credit; and recent and prospective developments in the payments mechanism, including experiments with direct deposit of payrolls, point-of-sale terminals, and other steps towards a complete electronic funds transfer system.

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Banking by mail came into its own in the late 1950s and early 1960s when the surge of economic growth in California created a local capital shortage and widened the interest rate differential between the East and West Coasts. Many people got their first taste of banking by mail by responding to the advertisements, placed by California savings and loan associations in Eastern newspapers, of what seemed at the time to be astronomical rates of return on share accounts. Once experienced, the convenience of banking by mail proved habit-forming to some customers. Just as an aside, I might observe that smaller banks could legitimately object to the subsidization of banking by mail implicit in postal rates that are unrelated to distance.

Preauthorized credit in the form of credit cards, check credit plans, and preapproved car loans for preferred customers clearly reduces the need to visit one's banking office. Given the infrequency of borrowing, as opposed to making deposits or cashing checks, the gain in convenience from the growth of these services may not be a serious problem for small banks, particularly if they join one of the national credit card plans as agent banks. Nevertheless, these forms of credit tend to increase the frequency of borrowing and, particularly for persons living in large metropolitan areas, may tip the scales toward banking at a large bank in the downtown business district rather than at a neighborhood bank.

Perhaps the biggest threat to small banks posed by recent and continuing technological developments lies in the area of the payments mechanism. Governor Mitchell of the Federal Reserve Board has pointed out that direct deposit of payroll by electronic means and the making of purchases by immediate electronic transfer of funds through point-of-sale terminals will eliminate most existing traffic in bank lobbies. I would like to quote

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Governor Mitchell on the significance of these developments. In his words, "the fact that proximity to customers is probably going to become less and less important has near-revolutionary implications for banking structure."

Still other developments that appear unfavorable for the future of the smaller independent bank are the continuing growth in the size of customers and their loan requirements, which have put an especially great strain on the ability of many agricultural banks to serve their farm customers; the continuing shift of population from rural to urban areas and the rapid growth of suburban areas which, as in the 1920s, are leaving some rural banks to wither on the vine; and the difficulty of paying for successor management by banks whose present managers are taking a substantial fraction of their remuneration in the form of the satisfaction and prestige that accrue to the banker in a small community. Most important, however--and this is as much a political as an economic development--there is a growing sentiment in favor of dismantling such barriers to competition as geographical branching restrictions, home office protection, stringent charter requirements, and interest rate ceilings on time deposits that have served, up til now, to protect the markets of smaller banks. As these barriers fall, these banks will face competition of an intensity they have never known. Indeed, as the recent granting of branching powers to savings and loan associations in Illinois illustrates, this competition need not come from within the commercial banking industry but may arise wherever an opportunity presents itself.

Finally--and it must be frankly acknowledged that this belongs in the "bad news" column--I should mention the Federal Reserve's recent proposal to extend reserve requirements to nonmember banks. This move has been widely interpreted as a "power play" aimed at the destruction of the dual banking system. Clearly, insofar as it would reduce the advantages of nonmember

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status, uniform reserve requirements could have some effect in this direction. But a balanced appraisal of the proposal requires that one make an important distinction between the Fed's role as a regulator of banks and its responsibilities for monetary policy. Because of an unexpected growth in nonmember relative to member bank deposits last year, the money supply grew at a rate well above that intended by the Federal Open Market Committee. By removing an important source of slippage and unpredictability in the effects of monetary actions, uniform reserve requirements can do a great deal to aid the nation in its quest for a soundly growing and noninflationary economy--a benefit which is clearly in the interests of all banks, large and small, and which dwarfs any inadvertent effect on the relative attractiveness of Fed membership. Of more direct importance to the smaller bank, the proposed exemption for the first $2 million of demand deposits moderates the potential impact on earnings of smaller nonmember banks.

So much for the storm clouds; in my introduction I promised you a silver lining. Perhaps the brightest ray of hope to appear through the overcast is the fact--recently documented by elaborate statistical studies but known by independent bankers since the year one--that, just as size is no automatic guarantee of sound and efficient banking, neither does smallness condemn a bank to competitive extinction. It is true that studies of economies of scale in banking do demonstrate that, for most banking functions, lower unit costs tend to be associated with higher levels of output. This is what economic theory would predict and is amply documented by the evidence. But another fact disclosed by the evidence is that the relationship is by no means perfect and that many small banks operate more efficiently than banks many times their size. What we can conclude is that size merely provides certain opportunities for increased efficiency; it does not insure that they

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will be exploited. Moreover, it underlines the strategic role of the individual bank's management in determining the actual outcome in terms of efficiency, regardless of the bank's size.

Another bit of sunshine is the finding of a study not so many years ago by the New York State Banking Department that the earnings of small banks were not adversely affected by the opening of a new branch of a large bank in the same local market. A caveat must be attached to this finding because the study did find that the small banks' growth rates tended to slow after the competing branch was established. Nevertheless, it demonstrates that the managements of smaller banks need not throw in the towel when the competition gets tougher. Indeed, the rapid rate of disappearance of independent banks in states liberalizing their branching and/or holding company laws suggests to me that some bankers have read the handwriting on the wall even before it was written. I hope that all of you will avoid a sense of panic when and if an unfamiliar neighbor opens an office next door.

Another point that needs to be remembered is that advances in technology do not always increase the advantages of large firms over smaller ones. To take a familiar example, the development of electrical power greatly reduced the efficiency advantage of combining many machines in a large factory and powering them all by a single large steam engine. Although there are great economies of scale in the generation of electrical power, this power can be transmitted efficiently and in minutely divisible amounts to widely scattered shops of many different sizes. Today, similarly, the development of specialized, limited function computers and time sharing on large, multi-purpose computers offer exciting possibilities for bringing the advantages of on-line computer processing of deposit and loan accounts to the smallest banks. At present, it appears to me that this development

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will most likely take place largely within the framework of the existing correspondent banking system.

Although, as I suggested in my discussion of bad news, some smaller banks will undoubtedly succumb to the intensified competition of the years ahead, it is vitally important from the standpoint of both equity and economic efficiency that this competition be based on a fair test of merit in the marketplace. An encouraging phenomenon in this regard in recent years has been the increased frequency and success of private antitrust suits, of which Control Data's suit against IBM is the largest and most visible. Not the least of the purposes of the antitrust laws is to assure that the results of competition reflect the relative efficiency and quality of service of the contestants in the marketplace rather than the advantages of unfair or predatory behavior. This applies to banks just as much as to other businesses.

In the final analysis, I have little doubt that it is the customers of banks who will make the choices that decide what form of banking structure we will have in the future. I know that many of you will disagree with my belief that existing barriers to competition in the banking industry can and should be removed to permit these choices to be fully effective. Some of you, knowing my background in the banking industry, may see in it a prejudice in favor of large banks. I must insist that this is not the case. Aside from my obligation as president of the Federal Reserve Bank of Chicago to serve the public first and to treat all banks in an impartial manner, I share with many other Americans a distrust of unchecked bigness, an instinctive tendency to favor the underdog, and nostalgia for the days when grocery stores delivered and clerks in retail stores were people with names. But nostalgia has its price.

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You all undoubtedly recall the great debate over the role of chain stores back in the 1930s. Several states imposed punitive taxes on them and there were numerous attempts at the federal level to prohibit chain stores altogether. Nevertheless, the chain stores prevailed and today they account for roughly 55 percent of the sales of retail food stores in the United States. How many of us would like to turn back the clock and return to the mom-and-pop grocery of yesteryear? I have no doubt that some would. Nevertheless, given a choice between the lower prices, greater variety, and impersonal service of the chain supermarket and the higher prices, smaller variety, and friendly treatment of the corner grocery, most consumers have opted for the former. I hasten to add that in the case of banking, individual treatment and personal relationships count for a great deal more than in food retailing, so the independent, smaller bank should fare much better than the corner grocery. But I would still argue that the issue should be decided in the marketplace, rather than in the state legislature or the halls of Congress.

As for what the future holds, my projection must be influenced by the experience of other states. Taking that as a guide, the process of consolidation in banking will continue in the years before us. A decade from now there could easily be on the order of 1,000 fewer banks and close to 5,000 more banking offices in the United States than today. Depending on whether present trends in legislation and regulation are continued or reversed, the process could go considerably further than that. But the result is not foreordained. Even under the most imaginative assumptions about the path the political process may take, the future role of smaller banks will depend primarily on whether they continue to display those virtues extolled by speakers at conventions of independent bankers associations and to adapt to the new needs of customers. This is the challenge you face today. I wish you well.

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