Industrial Development Bonds:
They're Not What They Used To Be

Corporate Treasurers and Their Depositories

Business, Households, and Their Banks
Industrial Development Bonds: They're Not What They Used to Be

. . . Financing of business facilities with tax-exempt securities issued by local governments has been curtailed. This may relieve some pressure on the tax-exempt bond market.

Corporate Treasurers and Their Depositories

. . . Treasurers of large corporations look to financial condition, location, size, and credit availability in selecting a bank.

Business, Households, and Their Banks

. . . Surveys of a banking market in central Bucks County reveal some characteristics of the relationships between banks and their customers.
During the past two years or so, there has been a running battle over industrial development bonds. Use of these bonds by municipalities and other political subdivisions, especially in the South, to persuade corporations to locate in a certain town or county has stirred much controversy. And industrial development bonds have become a political and sectional as well as an economic issue. During 1968, the U.S. Treasury, Congress, and the Securities and Exchange Commission took action to limit the role IDB's will play, beginning this year. Now that the dust has settled somewhat, it is possible to take an unimpassioned look at the IDB financing device and to assess the implications of its curtailment for municipalities, corporations, the capital market, and investors.

NATURE OF THE ANIMAL

Industrial development bonds (also called industrial revenue bonds, industrial aid bonds, and, mostly by opponents, tax-exempt corporate bonds) are issued by a municipality for the purpose of financing a factory or other industrial facility for lease to a business firm. Although they can be either general obligation or revenue bonds, the bulk are of the revenue type. The corporation which uses the factory usually pays "rent" to the town, county or development authority sufficient to pay the interest and principal on the bonds. Rental payments are a tax-deductible expense for the firm. Interest on IDB's issued before January 1 of this year, like the interest on other municipal securities, is considered tax-exempt so that investors owning the bonds pay no federal income tax (and often no state tax) on the interest received. Consequently, rates on IDB's are lower than rates on comparable corporate bonds, and the financing cost to the corporation is usually about 1 per cent less. For example, it has been estimated that the savings through industrial development
financing on a 30-year serial bond issue of $140 million could be as much as $25 million. On the other hand, IDB rates are higher than those on conventional municipal issues and repayment is guaranteed by the corporation, so they are attractive investments. For example, a tax-exempt bond yielding 6 per cent is the equivalent of a 10.91 per cent taxable return to a person in the 42 per cent tax bracket or 12.5 per cent to a corporation paying 48 per cent in taxes.

HUMBLE BEGINNINGS

The first IDB’s were issued back in 1936 in Mississippi to attract industry into depressed areas where employment and income were low. In 1950, only Mississippi and Kentucky allowed IDB financing; and although 23 states had authorized the practice by 1960, use of these bonds remained confined to relatively small towns in the South. Early IDB’s were not highly regarded by the nation’s financial community, largely because they were issued by small, often obscure towns for use by unknown companies. Nevertheless, they were popular with the municipalities and companies involved. For the town, there was an immediate increase in employment when the plant was being built and beginning operation. In addition there was the multiplier effect; that is, new jobs stemming from the plant, in turn, caused creation of still more jobs because business activities of local merchants, raw material producers and supporting firms expanded. For the company, it meant cheap financing, a large labor pool (which probably commanded lower wages) and possibly cheaper power and raw materials.

In 1954, the U.S. Treasury ruled that interest on IDB’s was tax exempt. This ruling spurred the spread of enabling legislation, as more and more states realized that IDB’s were a powerful device for attracting industry and furthering regional development.

STAMPEDE

Not only did the advantages of industrial development bonds attract more states and consequently more towns and counties into the field, but there was a snowballing effect. As use of IDB’s spread, towns in states which did not allow them found themselves at a competitive disadvantage to areas where they were allowed. By the end of 1967, a spirit of competition, as well as self-defense, led a total of 44 states to authorize the use of IDB’s by their political subdivisions. Even large industrial states like Ohio, New York and Pennsylvania joined the rush. During the 1960’s, IDB financing was no longer confined to the South, although the majority of issues still came from that section of the country.

As use of IDB’s spread geographically and as the economy expanded during the 1960’s, the number of IDB’s issued each year mushroomed. From $8.8 million in 1952, the total amount of industrial issues jumped to $84.3 million in 1962 and in 1968 about $1.5 billion of new IDB’s came to market. This rate of increase was considerably greater than that chalked up by all municipals, as shown in the chart. In every year before 1962, IDB’s counted for less than 1 per cent of dollar volume of new municipals, but by 1968 it is estimated that they represented about 9 per cent of the total.

Not only did the volume of IDB’s increase but characteristics of the typical issue changed, too. In 1957, average size of an industrial development issue was $366,000; in 1967 it was $7.8 million. This growth is spectacular compared to regular municipal bond issues; a typical tax-exempt offering grew from $1.0 million in 1957 to $2.5 million ten years later. The growth in average size of issue indicates that larger plants were being built with IDB financing and that larger corporations were benefiting from use of IDB’s.
At the same time, average population of towns floating industrial bond issues increased steadily, from 14,000 in 1965 to 33,500 in 1968. In the case of counties, growth was not quite as marked, moving from an average of 109,000 in 1966 to 156,000 in '67 and back to 140,000 in '68. Municipalities with nationally recognized credit ratings have also become more important as sellers of IDB's. Although the majority of towns are not rated by Moody's because of their small size (even in this sample of larger towns), from 1966 through 1968 almost 20 per cent of the IDB issues listed are from towns which are rated. No town issuing IDB's before 1966 was rated. The highest rating of an IDB-issuing municipality in our sample is "A" and the lowest "BA". Most are "BAA", which is considered of investment grade.

Yields on IDB's are higher than on other municipals, and this gap has been widening. A comparison between large issues of IDB's and the Investment Bankers Association Index for BAA-rated, 20- to 30-year bonds shows an average differential of 81 basis points in 1966, 109 in 1967, and 151 in 1968. For 5- to 10-year bonds, differences were 49, 56, and 107 basis points, respectively. Rising yields on IDB's relative to other municipals reflects the huge increase in supply of these bonds since 1965, and also a fear that the tax-exempt status of these bonds might be threatened. However, the increasing size of towns and companies involved in IDB financing would reduce the risk on these bonds, offsetting some of the above factors.

TO THE ATTACK
The surge in IDB issues attracted the attention of investors and dealers, the U.S. Treasury, organized labor and, eventually, the Congress. Much criticism of IDB's was heard and abuses of the device were reported. This induced vigorous rebuttals and a full-scale controversy developed.

Arguments against the continued use of tax-exempt industrial bonds are varied and wide-ranging. One which proponents have difficulty rebutting is that since almost every state allows IDB's there is no longer much competitive advantage to be gained for any particular town by using them. The situation is analogous to one in which the first gas station on the street to offer gifts, stamps or games boosts its sales considerably. Yet as competing stations find their own gimmicks, the advantage of the first
one is eaten away until all are back where they started.

Another practical consideration is the effect of the flood of IDB's on the municipal bond market. This sector of the capital market has been under severe pressure for a number of years for several different reasons. Demands for funds have grown as state and local governments face greater demands for services relative to their resources while the supply of funds, mostly from commercial banks and individuals in high tax brackets, has not kept pace. Thus, the growing volume of IDB's has aggravated a serious supply-demand imbalance rather than caused it. However, the addition of more than $1 billion in IDB's during each of the past two years helped keep interest rates high and prices of state and local bonds low. The effects were most marked in long-term, lower-rated issues.

Because interest income from IDB's is not taxable, the large and growing amount of these bonds held by individuals and institutions represents a sizeable loss of income to the Treasury. One federal authority projected a loss of $200 million a year by 1970, and $1.5 billion a year by 1975 if IDB's retained full tax exemption. Furthermore, some opponents, and at least one strong supporter of IDB's, feared that the amount of this revenue loss to the Federal Government together with alleged abuses of IDB financing would jeopardize the tax-exempt status of all securities. IDB's are also attacked as a tax loophole which helps the rich without providing offsetting public benefits. In reply, proponents argue that increased taxable corporate and personal income brought by a new plant help make up for loss to the Treasury caused by the tax-exempt feature of IDB's. Some even conjecture that federal money is saved through use of IDB's because economic development of a region makes federal assistance programs unnecessary there.

Organized labor is opposed to IDB's because of sudden mass unemployment caused in an area when a plant leaves (usually from the highly organized East) to relocate at an IDB-financed site in the less-unionized South. IDB's also have been called a perversion of and a threat to private enterprise. For example, it is said that this kind of financing prompts uneconomic plant location; that it obligates the firm unnecessarily to the community; that competition among firms in an area is threatened if one company has the advantage of industrial bond aid and others do not; that use of IDB's smacks of Socialism; that IDB's provoke plant piracy—a sort of "beggar-thy-neighbor" policy among the states. Those who favor IDB's reply that firms cannot be lured to a particular site by a financing gimmick alone; economic considerations must still play a major role in the site-location decisions.

Finally, some observers contend there are abuses of IDB financing. Some feel use of IDB's in Northern industrial states is inappropriate. Others point to a growing list of large and successful firms which have benefited from IDB's. For example, a recent decision by the Pennsylvania Supreme Court permitted IDB financing for plants to be used by Ralston Purina and Armco Steel. There have also been instances where large firms and large plant facilities placed a heavy tax burden on towns where they located because of new water and sewer facilities they required. Detractors also claim that companies buy many of their own IDB's, thus turning tax-deductible interest payments into tax-free income as well. A survey of Fortune's 500 largest firms in 1967 revealed only two examples of a firm holding IDB's originally issued to finance its own facilities, but the nation's top 500 include only a small fraction of all firms leasing plants financed by IDB's.

Perhaps the most important point made by
those favoring development bond financing is the economic boost it can give to a community. A new plant results in higher employment, higher incomes and more business for merchants and service industries. Some enthusiastic supporters of IDB's say the financing device encourages people to remain in rural areas and small towns instead of joining the exodus to urban centers and ghettos of the North.

YANK ON THE REINS

Early in 1968 the Federal Government started to crack down on IDB’s. The Securities and Exchange Commission proposed a ruling which would require industrial development issues to be registered. This process would complicate each offering and make it more expensive. In the spring of 1968, the Treasury prepared to end tax exemption of IDB's by administrative ruling. But Congress, particularly the Senate, saw this as a usurpation of legislative prerogative and hastily attached a rider to a bill, ending tax exemption of these issues by Congressional action. The amendment was eventually signed into law in June as part of the Revenue and Expenditure Control Act of 1968, the surcharge-spending act. A further change was made in October restoring tax-exemption for issues meeting certain tests.

As of now, interest income from industrial development bonds issued since December 31, 1968 will be taxed, unless the IDB issue is less than $1 million, or unless the total of the IDB issue plus any capital expenditure by the benefiting firm in the municipality for three years before and after the issue is less than $5 million. IDB's floated for certain purposes are also exempt: housing, sports facilities, convention facilities, transportation facilities, air or water pollution control, development of sites for industrial parks.

IDB’s of over $300,000 are now subject to registration with the SEC, according to an August, 1968 ruling by the Commission. Also, the Internal Revenue Service recently decided that corporations will no longer be able to deduct all rental payments on IDB-financed facilities as a business expense. Now firms can deduct only an amount equal to interest payments they would have made had they borrowed in the corporate market to build the facility.

Faced with these grim conditions, many firms and municipalities rushed to market with IDB issues before the December 31st deadline. Now, however, the end of tax exemption has marked the end of large issues of IDB’s. What alternatives will cities find to lure industry? How will corporations react? Will this affect the capital markets and institutional and individual investors?

WHERE DO WE GO FROM HERE?

Some issues of industrial development bonds will still be marketed. Underwriters report that even as the new rules went into effect a few towns were preparing small offerings of IDB’s. However, in 1967, issues of $5 million or less accounted for only 13 per cent, or about $160 million, of total volume of IDB’s. The new SEC registration requirements and capital spending limitations will also discourage prospective issues because towns and companies may find the benefits of marketing small issues of IDB’s are not worth the costs. The number of issues which will appear under the various exceptions is not known. Many feel that future IDB’s will be within the original purpose of boosting the economy of small towns, and that the danger of abuse will be diminished.

With the stampede of new IDB issues slowed to a crawl, the market for municipal bonds will feel much less pressure from this source. The absence of year-end bunching of offerings which
has occurred for several years now will be a particular relief. Also, the psychological impact that growing volume of IDB's had on an already demoralized market will be removed. Nevertheless, even a large cutback in industrial issues will not be able to arouse the market from its depression because increasing needs of communities will continue to make heavy demands on the municipal market. Legislation and rulings prohibiting large IDB's were more important in terms of what they prevented—that is, a further avalanche of these bonds—rather than effects which will actually be observed.

There will be increased demand for funds in the corporate bond market as firms banned from use of IDB's seek alternative means to finance new plants. The severity of these extra pressures depends on the extent to which companies using IDB's have been borrowing in the corporate market already, but there is no evidence available on this point. In 1967, total issues of IDB's equaled 6.25 per cent of corporate market volume (up from .02 per cent ten years before).

The impact of increased corporate demands, because of curtailment of financing with industrial development bonds, is difficult to measure. The impact should not be staggering because the corporate market is a more robust one. But if capital spending by business is as high as now predicted, additional corporate issues could be an annoying problem for an overburdened market.

In the past the same types of investors who bought regular municipals have bought industrial development bonds: commercial banks, well-to-do individuals and insurance companies. Banks buy a somewhat smaller proportion of industrial development bonds because they typically buy shorter-term bonds whereas only 20 to 30 per cent of most IDB issues is included in the shorter-term, serial portion of the bond. Most investors who formerly bought IDB's probably will continue to buy municipals in order to receive tax-free income. Relative attractiveness of outstanding industrial development bonds to investors depends on expectations: will investors decide the new legislation and rulings are only the first phase of an attack on tax exemption of all IDB's or will they assume these actions assure continued tax exemption of interest on outstanding industrial revenue issues?

Smaller cities and counties may still find it beneficial to issue industrial bonds under limitations currently applied. Larger ones must find alternative ways to promote economic development of their regions. To a certain extent, along with all municipalities, they should profit from lower municipal rates for all general obligation and revenue bonds than would have existed had the glut of IDB's been allowed to continue. For those actively seeking to attract industry, loopholes in the law still allow IDB-paid-for industrial parks and transportation facilities. A recent issue of the *New England Business Review*, Federal Reserve Bank of Boston, suggests that state loan and loan guarantee programs, which already exist in a number of states, can be effective supplements to private lending for regional development.

The future of industrial development bonds has not been irrevocably determined; Congress may reconsider them. Partly because there never were committee hearings on the amendment which removed their tax exemption, some commentators feel more changes, or at least reevaluations of past actions, are in store. Although the possibility is still remote, industrial development bonds may rise again. In the meantime, this device will return to its original role of luring smaller firms into small, possibly depressed, but aspiring communities.

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Commercial bankers trying to win demand deposits of large corporations have a difficult task. They face vigorous competition not only from other banks and institutions but also from financial markets. While banks aggressively vie for their business, treasurers of major corporations increasingly are turning away from banks. The volume of commercial paper is soaring as firms secure funds through that medium—depriving banks of the opportunity to grant credit directly to corporations. And more sophisticated treasurers are keeping deposits at rock bottom by investing idle funds in commercial paper, Treasury bills, certificates of deposit and municipal debt. So, banks are tending to miss out at both ends—they are losing lending opportunities as well as demand deposits to markets for other financial assets.

Nevertheless, corporate business still dominates the activities of many banks and corporate deposits still account for a huge chunk of total deposits, especially at bigger banks. Although the market for demand deposits of large corporations is just one of several in which banks compete, it deserves particularly close and continuous analysis by bankers who participate in it. Therefore, we have checked with treasurers of the nation’s largest corporations to determine some of the characteristics and dimensions of this market.

NATURE OF THE MARKET

The main struggle in the market for corporate demand deposits involves treasurers and bank-

1 Just over 20 per cent of the corporations in our survey owned municipal securities while nearly 30 per cent held U.S. Government securities. Roughly 14 per cent of the respondents invested in both federal and state and local debt.

2 A questionnaire was sent to the treasurers of corporations included in Fortune’s listing of the 500 largest firms. Responses to some or all of the questions were received from about 64 per cent of the treasurers. Because only giant firms were included in the sample, information reported here may not apply to other corporations.
ers. Treasurers want to shrink their demand deposits to the bare minimum while each banker tries to expand deposits at his institution. Deposits are especially important to bankers because they are the main input for loans which are the principal earning assets of banks.

A banker may gain demand deposits by convincing a treasurer that his bank is a convenient place to keep temporarily idle funds. But this approach is proving less successful because treasurers are busy figuring out ways to minimize their idle funds. Rather than keeping funds in non-earning deposits, corporate officials are increasingly investing them in Treasury bills, tax-exempt municipal notes, and negotiable certificates of deposit. Each of these assets is highly liquid and each provides an explicit monetary return to the firm. So, bankers are finding that the pool of idle corporate balances is drying up—especially during periods of high interest rates.3

Bankers traditionally have required corporations to hold balances on deposit in exchange for other services provided by banks. Deposits, then, become a kind of medium of exchange with which firms purchase services. For example, at least part of the price of a bank loan is expressed in terms of deposit balances. Investment advice, payroll accounting, and numerous other services banks sell can or must be bought partly, if not entirely, with deposits. The barter system, long ago proven too cumbersome for efficient functioning of most markets, still hangs on in markets for bank services.

Despite the inefficiency of bartering, bankers cling to it for a couple of reasons. First, deposits are crucially important to a bank as a source of loanable funds, and the practice of requiring compensating balances helps maintain a bank's deposit base. Second, the practice also probably reflects a desire on the part of bankers to avoid explicit price competition in the market for deposits, thereby enabling them to compete on terms other than price. Of course, Regulation Q issued by the Board of Governors of the Federal Reserve System currently prohibits payment of interest on demand deposits and, consequently, provides a barrier to explicit price competition for such deposits. Prior to Regulation Q when banks did pay interest on demand deposits, they also required compensating balances for partial payment for other services.

NUMBER OF DEPOSITORIES

There is a lot of corporate business available for banks because most large corporations maintain deposits in a number of banks. Depositories fall into two categories—major ones where the bulk of the firm’s working balance is kept and minor ones used primarily for payroll disbursements and lock-box receipts.4 All respondents reported maintaining at least one major depository and four-fifths of them had one or more minor depositories. Well over half of the corporations had major depository relationships with 10 or more banks—and nearly 8 per cent had over 50 major depositories.

Most corporations had more minor depositories than major ones. Over 70 per cent of those firms having any minor depositories had 10 or more. About one-third had over 50, and over 5 per cent kept deposits at more than 450 banks.

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3 Bankers are able to secure some corporate funds by selling certificates of deposit to the firms. Of course, banks must pay interest on these deposits. At times like the present, however, market rates on Treasury bills and other short-term investments may exceed the maximum rate permitted on C.D.’s.

4 Many corporations use two types of major depositories. One type is called a concentration bank wherein receipts originally deposited in minor depositories are pooled. The other is a headquarters bank which provides a wide range of services to corporate customers.
Not all banks holding a corporation’s deposits get the opportunity to lend to the firm because corporations typically secure credit from fewer banks than they patronize with their deposits. Still, large firms tend to establish lines of credit at a number of banks. Nearly a third of the respondents reported borrowing or maintaining lines of credit at from 5 to 9 banks. Just under half of the firms had credit arrangements with 10 or more banks. And at the extreme, a few corporations borrowed or held lines of credit at more than 65 banks.

These data indicate that large firms spread their deposits about rather extensively and that their credit business is parceled out less widely. The large number of depositories stems principally from efforts of corporate treasurers to maximize available cash by streamlining systems for gathering and disbursing funds. Treasurers want to get their hands on customers’ checks as quickly as possible. So, rather than waiting for the mail service to deliver a check from a customer in, say, Little Rock, to a headquarters bank in Philadelphia, a firm may direct the customer to remit to a depository bank in Memphis. As soon as the money gets to the Memphis bank, the firm can speed the funds to a disbursement bank in some nearby state where the firm may have a plant or where suppliers may be located. The net result of such a system is efficient use of funds so that the minimum amount need be maintained. Lofty interest rates prevailing during the past few years have provided added incentive for corporations to use funds more efficiently.

### What Treasurers Look For

Basically, corporate treasurers look at several factors—Independently as well as collectively—in selecting a commercial bank. As shown in the table, there was not much agreement among respondents as to which of the factors was most important. However, when first, second, and third rankings for each factor were grouped together, four selection factors came out about the same (as shown in the far right column of the table).

#### Financial Condition

The financial condition of a bank is of first importance to more treasurers than is any other selection factor. Much of the attention given to a bank’s financial condition centered upon its capital position. More than nine out of ten treasurers expressed considerable concern over the adequacy of their depositories’ capital and many treasurers have gone to great lengths to assess the adequacy of banks’ capital. But this concern over financial condition in general and capital adequacy in particular was prompted more by concern for the size of credit accommodation available than for safety of the corporation’s deposits.

Financial officials at a number of major corporations believe that they need not worry about the safety of their deposits since the bulk of

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5 This finding is consistent with that of a similar study made a dozen years ago. See George Hanc, “How Corporate Treasurers Select Their Depositories,” Banking, (March, 1957).

them is in the larger banks. Presumably, the view is that large banks cannot fail or, indeed, would not be allowed to fail by supervisory agencies charged with maintaining the viability of our banking system. Moreover, in the case of many major depositaries, corporations frequently owe the banks more than the banks owe them. Consequently, as net borrowers, firms may feel they have little to lose should their banks become financially embarrassed. In the case of minor depositaries, the relatively small size of deposits at any of these banks may reduce the need for great concern over safety of these deposits.

Credit availability is tied to a bank’s financial condition in several ways. For example, national banks as well as many state banks cannot lend to any one borrower an amount greater than 10 per cent of their capital stock and surplus. So, the bigger a bank’s capital, the more a corporate treasurer can probably borrow there.

Most treasurers also pay attention to other facets of a bank’s financial condition—particularly the volume of loans already on its books. If a bank has loaned out about as much money as it may prudently lend, there may be little chance of the firm negotiating credit. This consideration probably has assumed greater importance in treasurers’ eyes following the credit crunch of 1966 when firms were clamoring for more loans and larger lines of credit than banks could grant.

To keep tabs on banks’ financial conditions, about 40 per cent of the treasurers used ratio-analysis techniques. Favorite financial ratios were loans to deposits, capital to loans, loans to assets, and capital to total deposits.

**Location.** For one-fifth of the respondents, the most important factor in choosing a depository was its location. Major depositaries of the largest corporations usually are located near the firm’s principal base of operations, in the nation’s leading financial centers or, in the case of concentration depositaries, in principal cities across the land. This means that banks outside of those places have to look primarily to locally based firms for corporate deposits.

Minor depositaries used mainly for payroll accounts nearly always are located close to the facility which they serve. Lock-box depositaries are selected mostly on a geographical basis in areas where corporate depositors have concentrations of customers. Because banks serving as minor depositaries need not be particularly large, there are many banks competing in this sub-market. And the competition tends to be intense. There are indications, however, that once a bank has been selected as a minor depository, chances are good it will keep the account because large firms tend not to switch banks very much. Of course, they may add additional banks to their network of depositaries but they rarely drop any.

**Size.** Fourteen per cent of the treasurers said that size was the most important selection factor as far as they were concerned. Financial officials leaned toward larger banks in choosing depositaries.

Larger banks, on balance, are able to offer a wider range of services required by treasurers. Specific services mentioned by respondents included investment advice, use of international facilities and contacts, and handling of pension funds. Moreover, treasurers reported that their depository relations with larger banks tend to insure availability of an adequate volume of credit.

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7 Perhaps these firms may be more exposed to loss than they think should the bank fail. The law usually does not provide the “right of offset.” Consequently, a customer of a failed bank cannot deduct the amount of his deposit from the amount he owes. Receivers or trustees charged with wrapping up the bank’s affairs can move to force payment of the loan balances.
Some financial officials of major corporations equate size with safety—the larger the bank, the less likely it will become insolvent. The reasoning apparently is that assets of huge banks are more widely diversified than those of smaller institutions. Also, some treasurers believe that the costs of failure of a giant bank is so great that supervisory agencies would not permit one to fail.

Credit Accommodations. Nearly a fifth of the respondents stated that availability of adequate credit accommodations was their principal criterion in selecting depositories for corporate funds. The importance of bank credit to efficient operations of business firms is well understood and nobody understands it better than treasurers of giant corporations. Therefore, in choosing a depository, treasurers often reward those banks which promise and deliver credit when it’s needed by the business.

Of course, most banks, both large and small, still follow the old custom of requiring borrowers to keep a deposit balance as partial compensation to the bank for granting a loan. This compensating balance, as it is called, usually equals 20 per cent or so of the amount of the loan. Compensating balances increase the effective interest rate on loans because borrowers do not get to use all the money they borrow—yet they pay interest on the full amount. Just how much more costly compensating balances make a loan depends upon the average size of the borrower’s usual working balance and the distribution of that balance among depositories. It is not surprising that many corporate officials who are able prefer to borrow in the commercial paper market, usually at lower interest costs. However, ability to raise funds in the commercial paper market partly depends on the firm’s credit lines available at its bank. And banks granting lines of credit frequently impose compensating balance requirements.

Management Contacts. Only 7 per cent of the treasurers said that personal contact between officials of the bank and the firm was the most important factor in selecting a depository. To some extent, of course, management contact is involved every time a depository is selected because bank management carries out the personal marketing effort. But only seven out of every hundred corporate treasurers believed management contacts were even more important than a bank’s financial condition or its location. Some of these contacts may stem from interlocking directorates, mutual investments or just old friendships.

SUMMARY

Although sophisticated cash management techniques have reduced the total volume of temporarily idle funds for the typical giant corporation, at the same time they have increased the number of depositories the firm is likely to have. Because of the dearth of price competition in the market, the bulk of a firm’s deposits goes to banks which are able to promote themselves on the basis of nonprice factors which the corporate treasurer looks at in selecting a depository. The most important of these factors were financial condition, location, size of bank (largely a proxy for variety of services available) and credit availability. Should federal regulations ever permit payment of explicit interest on demand deposits, bankers may have to abandon the barter system in which deposit balances are maintained in exchange for services performed by banks. A dollar price for each bank product would lead to more efficient markets for those products.

8 The actual proportion of treasurers placing primary emphasis on availability of credit probably far exceeds the 20 per cent figure. As indicated earlier, some of the concern over size and financial condition boiled down to concern over credit availability.
Bankers are keenly interested in the preferences and behavior patterns of their customers. The wants of businessmen as well as of households and bankers’ response to these wants determine the nature of banking markets. Two surveys undertaken by the staff of this Bank shed some light on the characteristics of banking markets in the central portion of Bucks County centered on Doylestown.¹

**BUSINESSSES AND THEIR BANKS**

The business population of central Bucks County consisted mostly of small firms. Approximately 80 per cent of the firms had 25 or fewer employees and about nine out of ten had a net worth under $75,000. Moreover, the omission from the sample of all branch firms with headquarters outside central Bucks County removed the influence of some larger firms from the survey results.³

**Most Firms Banked Locally.** Business firms in central Bucks County had chosen as their primary banks those with an office, either the main office or a branch, nearby. Roughly two-thirds of the firms selected as their main bank one with its home office in Bucks County. Generally, the remainder used as primary banks ones having home offices outside the county, but with branch offices within the central Bucks County area.

¹ The staffs of the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of Philadelphia cooperated in the research design of both surveys. A market research firm, Behavior Systems, Inc., of Philadelphia, was retained as a consultant in the business firm survey and to conduct the household survey.

² Information on the business-bank relationship was secured through personal interviews with firms in central Bucks County. The firms constituted a stratified random sample which was selected from a total business population of 687 firms, drawn from the Dun & Bradstreet listing of September 1, 1967. Of these, 179 were originally designated for sampling. Interviews were successfully completed in 147 cases. The interviewing was done in December, 1967 and January, 1968.

³ This exclusion was based on the assumption that the home office, rather than the branch, normally makes decisions pertaining to selection and use of commercial banks and services.
The area covered by the two surveys is shown as the shaded portion on the map. Located within the Philadelphia Standard Metropolitan Area, Bucks County has undergone marked changes since 1950. Its industrial, commercial and residential expansion was accompanied by a more-than-doubling of its population during the 1950-60 decade. The most dramatic changes in its economic make-up took place in the lower portion of the county where the United States Steel Corporation built its integrated steel mill in Morrisville. In the 1960’s, the expansion of economic activity carried into the county’s central portion with the result that the area’s pastoral and small-town setting began a transformation that most observers expect to continue to 1980 and beyond.
For those firms with more than one banking connection, the same marked preference for local banks was in evidence. In fact, more than 60 per cent of the firms in this group designated one or the other of the two Doylestown banks as their secondary bank.

While it is not known what factors motivated the firms in their initial selection of a primary bank, it appears that physical convenience was important. Approximately three-quarters of the businesses generally did their banking at an office that was within five miles and normally reached within ten minutes. Only 10 per cent of the businesses used a banking office that required 20 minutes or more travel time from the place of business.

Most Firms Used One Bank. Approximately 70 per cent of the business firms in central Bucks County used a single commercial bank for all of their banking needs. By contrast, 24 per cent of the firms used two banks and 6 per cent used three or more. Larger firms—those with an estimated net worth of $75,000 or more—showed, as expected, a higher incidence of multiple-bank usage than the smaller firms. Forty-two per cent of these firms used two or more banks. Apparently, most of the area’s business firms, being small, have not seen any reason to seek more than one banking connection.

In central Bucks County, the typical bank-business relationship is one of long standing. About three-fourths of the firms have dealt with the primary bank for at least five years, about one-half for ten years or more, and approximately a third for 20 years or more. Of course, since new firms would cause these results to be understated, the clear implication is that business firms change banks only infrequently.

Banks in recent years have placed more emphasis upon direct solicitation as a source of new business. In the central Bucks County area, one-third of the firms had been contacted by at least one bank. Given the large number of small firms in the area, it might be expected that marketing efforts of banks would have focused on the larger firms almost exclusively. But this was not the case. Only 41 per cent of the larger firms (net worth of $75,000 or more) had been called upon by bankers seeking new customers. However, a few of these firms had been contacted, on several occasions, by three or more of the large Philadelphia banks.

Business firms in central Bucks County were generally well satisfied with the quantity and quality of services that they received from their banks. More than 88 per cent of the firms rated the quality of their banks’ services as being good or excellent. By contrast, less than 4 per cent considered the service of their banks poor. Moreover, only 7 per cent of the firms expressed a desire for additional banking services that were not being offered by the area’s banks.

Use of Bank Services. Most of the firms in central Bucks County used two banking services: checking accounts and loans. Virtually all firms had one or more checking accounts with their primary bank, and about three-quarters had borrowed from it. The next most frequently used banking service, the safe deposit box, was used by less than one-third of the business firms. Use of bank services is shown in Table 1.

<table>
<thead>
<tr>
<th>Service</th>
<th>Per Cent of Firms Using Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>Checking account</td>
<td>98.0</td>
</tr>
<tr>
<td>Bank credit (business loans)</td>
<td>78.1</td>
</tr>
<tr>
<td>Safe deposit box</td>
<td>31.1</td>
</tr>
<tr>
<td>Time deposits or C.D.’s</td>
<td>16.2</td>
</tr>
<tr>
<td>Business advice</td>
<td>13.6</td>
</tr>
<tr>
<td>Trust services</td>
<td>8.8</td>
</tr>
<tr>
<td>International banking services</td>
<td>2.0</td>
</tr>
<tr>
<td>Other</td>
<td>6.6</td>
</tr>
</tbody>
</table>

About three-fourths of the central Bucks County firms borrowed from their primary bank. Of these, roughly 70 per cent had a loan outstanding at the time of the survey. For most, the level of their last borrowing was comparatively
modest, reflecting in large measure the small size of the area's firms. As shown in Table 2, the last loan was under $5,000 for about 39 per cent of the business firms. For 86 per cent, it was under $25,000.

<table>
<thead>
<tr>
<th>Bank Size</th>
<th>Per Cent of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $5,000</td>
<td>38.5</td>
</tr>
<tr>
<td>$5,000 to $9,999</td>
<td>24.4</td>
</tr>
<tr>
<td>$10,000 to $19,999</td>
<td>22.7</td>
</tr>
<tr>
<td>$25,000 to $49,999</td>
<td>8.3</td>
</tr>
<tr>
<td>$50,000 to $99,999</td>
<td>2.6</td>
</tr>
<tr>
<td>$100,000 to $149,999</td>
<td>1.1</td>
</tr>
<tr>
<td>$150,000 to $249,999</td>
<td>0.9</td>
</tr>
<tr>
<td>$250,000 or more</td>
<td>1.4</td>
</tr>
</tbody>
</table>

*Because of rounding, per cents do not add to 100.*

A similar pattern existed for those firms dealing with more than one commercial bank. Of these, approximately four out of ten borrowed from their secondary bank and the majority had a loan outstanding at the time of the survey. Here, too, the general pattern of loan size was comparatively modest—about three-fourths of the firms indicated their last loan was under $25,000, with more than half under $5,000.

Most central Bucks County firms did not seek out alternative suppliers of bank credit—that is, they did not "shop" for loans. Nine out of ten of the borrowers had not discussed their credit needs with other banks. Of those who had borrowed from their secondary bank, the results were not substantially different. Of this group only 15 percent had discussed their credit needs with at least one other supplier. Failure to investigate alternative sources of credit may stem from the close, long-standing relationship between firms and their banks.

**Use of Nonbank Financial Institutions.** Roughly 16 per cent of central Bucks County firms have had dealings with nonbank financial institutions. Firms named savings and loan associations, finance companies and insurance companies, in that order of frequency. Savings and loan associations and insurance companies were used most often for mortgages; finance companies generally were used to discount business loan paper.

**HOUSEHOLDS AND THEIR BANKS**

**Banking Services Used.** On average, 19 out of every 20 households in central Bucks County used one or more commercial banking service. As expected, checking accounts were most widely used—88 per cent of the households used one or more. This is substantially above the national average. The Survey Research Center at the University of Michigan estimates that 68 per cent of the households in the United States had one or more checking accounts in 1967. One factor explaining the higher incidence of checking account usage in central Bucks County is that average family income is well above the national median.

Approximately 79 per cent of the households had at least one savings or share account. One-third of them were with non-bank financial institutions, primarily savings and loan associations and mutual savings banks, and two-thirds were in the form of savings deposits with commercial banks.

Some of the 12 per cent of the households which did not have checking accounts did use other services offered by banks. Nearly 8 per cent of the area householders, while they had no checking account, had a savings account at a bank. The banking services used by the non-checking segment of the area's population are shown in Table 3.

Roughly half of the respondents indicated that...
they had not made use of services of financial institutions other than checking and savings deposits within the past three years. About 25 per cent of the households had received auto loans and mortgage loans during that period. Approximately three-fourths of those borrowing had obtained an auto loan from a bank, and the remaining one-fourth from finance companies and credit unions. By contrast, only 29 per cent obtained mortgage funds from a commercial bank with the majority having borrowed from either savings and loan associations or mutual savings banks.

About one-third of the respondents indicated they had rented a safe deposit box. In nine out of ten cases, they got this service from a commercial bank.

Factors in Bank Selection. Convenience to the home emerged as the single most important reason for selection of a particular bank as a depository for the main household checking account. Almost one-half of the respondents cited this reason, as shown in Table 4. By contrast, only about 10 per cent of the households considered convenience to work as a deciding factor. The strength of the convenience-to-home motive is surprisingly strong inasmuch as there is substantial commuting to work to other parts of the Delaware Valley.

**IMPLICATIONS OF THE FINDINGS**

Because characteristics such as population, industrial mix, and personal incomes vary among geographical areas, information about banking markets in one area may not hold true for those in another region. But studies of markets in six areas have been completed and they do give rise to some general, if tentative, observations about the nature of banking markets.5

**Localized Demand for Banking Services.** All of the studies confirm the prevailing belief that, for the majority of business and household customers, the demand for the services of commercial banks tends to be highly localized. Larger corporations usually take a broader regional or national view when considering banking connections, but evidence suggests this is not the case for smaller businesses and households. The small firm or family with primary banking con-

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nections beyond the local area stand as distinct exceptions.

High incidence of usage of local banks uncovered in the central Bucks County surveys has also been found elsewhere. In Appleton, Wisconsin, for example, more than 90 per cent of the business firms used local banks while only 3 per cent had their primary banks in Chicago or Milwaukee. Virtually all business firms in Elkhart, Indiana, considered a local bank as their primary bank, while in only two out of 141 cases in Cedar Rapids, Iowa, was the principal bank located outside the area (Linn County, the Cedar Rapids SMSA). The same pattern of local bank usage by households emerged in each case that was studied. Even in the case of householders in Elkhart using bank-by-mail facilities, three-fifths used local banks and another one-fifth used nearby banks.

The Role of Convenience. The frequency with which householders in central Bucks County cited convenience in the selection of the primary bank has been noted. Perhaps surprisingly, the original bank choice of a large number of business firms is explained on the same grounds. Other surveys revealed similar, although not identical, findings. Convenience and personal preference were the reasons most often given by business firms in Cedar Rapids. In Appleton, convenience ranked second only to quality of services as a motive for the selection of a primary bank. The same general pattern emerged in Elkhart.

An implication of these findings is that for a large number of households, and a lesser but significant number of small business firms, banking output might initially be viewed as a “convenience good.” Such a good, or in this instance, service, is one in which the buyer thinks it is not worth his time or trouble to investigate alternative sources of supply. If this is correct, it implies that some households and business firms approach the bank-selection decision with the belief that “banks are all alike” and the likely result is that customers chose the bank most conveniently located.

The Bank-Business Relationship. Finally, the empirical investigations of banking markets serve as factual reminders that, once established, the relationship of a business firm with its bank tends to be long-standing. The typical business firm does not take its banking connections lightly. Firms rarely shop for loans, attempting to play one bank against another in search of better price or terms. Bank switching is not common. For example, large firms in St. Louis, on average, had been customers of their primary banks for over a quarter of a century and 18 per cent reported a relationship with their primary bank spanning more than 50 years.

The evidence further suggests that when a firm severs a banking connection, it is likely to be in response to what it considers to be a serious breach of a past relationship. Thus, a loan denial, curt or cavalier treatment by bank employees, or the like, rather than simply the firm’s ability to obtain a “better deal” elsewhere are likely to lead to changes in banking connections.

In conclusion, these studies reflect patterns of bank usage in only six of the literally thousands of banking markets and submarkets in the nation. And, the studies of business firms tend to minimize the preferences of large corporate customers whose dealings with banks may be quite unlike those of the typical small firm. Thus, the reader is cautioned against making undue generalizations regarding all banking markets. Nonetheless, the analysis presented does serve to reveal some interesting common patterns of behavior in specific banking markets and suggests that such patterns may, in fact, exist in markets with the same general characteristics.
### SUMMARY

<table>
<thead>
<tr>
<th></th>
<th>Third Federal Reserve District</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Per cent change</td>
<td>Per cent change</td>
</tr>
<tr>
<td></td>
<td>Jan. 1969 from mo. ago year ago</td>
<td>Jan. 1969 from mo. ago year ago</td>
</tr>
</tbody>
</table>

**MANUFACTURING**

- Production
- Electric power consumed
- Man-hours, total
- Employment, total
- Wage income
- CONSTRUCTION
- COAL PRODUCTION

**BANKING**

- (All member banks)
  - Deposits
  - Loans
  - Investments
  - U.S. Govt. securities
  - Other
  - Check payments
- (All member banks)
  - Deposits
  - Loans
  - Investments
  - U.S. Govt. securities
  - Other
  - Check payments

**PRICES**

- Wholesale
- Consumer

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### LOCAL CHANGES

<table>
<thead>
<tr>
<th>Standard Metropolitan Statistical Areas*</th>
<th>Employment</th>
<th>Payrolls</th>
<th>Check Payments**</th>
<th>Total Deposits***</th>
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<tbody>
<tr>
<td></td>
<td>Per cent change Jan. 1969 from mo. ago year ago</td>
<td>Per cent change Jan. 1969 from mo. ago year ago</td>
<td>Per cent change Jan. 1969 from mo. ago year ago</td>
<td>Per cent change Jan. 1969 from mo. ago year ago</td>
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<tr>
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<td>+18</td>
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<td>0</td>
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<td>+14</td>
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<tr>
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<td>+15</td>
</tr>
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<td>-2</td>
<td>+4</td>
<td>+10</td>
</tr>
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<td>0</td>
<td>+4</td>
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<td>-7</td>
<td>0</td>
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</tbody>
</table>

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*Not restricted to corporate limits of cities but covers areas of one or more counties.

**All commercial banks. Adjusted for seasonal variation.

***Member banks only. Last Wednesday of the month.

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*Production workers only

**Value of contracts

***Adjusted for seasonal variation

†15 SMSA's

‡Philadelphia