

INDEPENDENCE AND THE INDEPENDENT BANK

Part 6 of a series: What independence means to our markets

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Blogger Ed O'Leary has been considering facets of the future of community banking, as seen through the lens of lending. This week he probes what independence means to community banks and why it is critical to them. You can start at the beginning of the series [here](#).

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This is Independence Week, when we celebrate our nation's independence and reflect on what it means to us as a political and economic society. Does the term "independent" as we use it relating to our national identity have any relevance to the way community bankers use the term?

Independence, according to the dictionary, means "not subject to the control of others." But for community bankers, who are the "others" from whom we choose to separate and become identifiably different?

Independence of thought and viewpoint

I suppose most community bankers, me included, would consider the separateness to relate to those individuals or owners whose values and business objectives are not closely aligned to our own.

We can think of the differences in a variety of ways: product, geography, outcomes, and impacts, to name some important categories.

In turn, much of this discussion in recent years is shaped, like it or not, by our regulatory structure.

Bank supervision has two principal goals:

- First, to assure a safe and sound banking system by protecting the integrity of the payment process.

- Second, to effect public policy in certain banking activities such as fair and appropriate interest rate disclosures, absence of discriminatory practices in the access to and costs of credit, and the like.

The overarching goal is aimed at the public good by protecting our money supply. That resides largely on the balance sheets of banks. Secondly the structure allows for the expressed will of the people through banking law that is administered and enforced by bank supervisory authorities.

These objectives are shared in common by banks of all sizes. But the impacts on the public--and inferentially on whose definition of the "common good" applies--are much more complex.

How CRA puts debate into a nutshell

The Community Reinvestment Act affords some convenient contrasts.

CRA was originally designed to eliminate the effects of alleged discrimination in real estate credit availability and cost as measured by where loans were being made (and neighborhoods where there was an underrepresentation of such loans). Many of us have lived through the tortuous history of the act and its implementation at the hands of sometimes all-too-"enthusiastic" bank regulators.

In terms of the impact on the activities of locally owned banks with relatively limited geographic territories, it's pretty simple to see the sense of what the law is trying to achieve. The basic premise is that a community's deposit resources should be broadly available in the form of bank credit in the local community.

Where local institutions derive nearly all of their sources of funds from local deposits and retained earnings (from presumably local shareholders), the law is a model of simplicity. But what of large banks that fund themselves from a variety of sources including extensive non-deposit sources or that gather their deposits across huge geographical territories?

It has always seemed to me that the chief constituency of any bank, large or small, consists of the marketplace and of the individual components of the marketplace. Understood in these terms, the principal criteria for defining one's business base and product lines for very large banks compared to small institutions are quite different.

Community bankers have long argued that a local community is best served by financial institutions that are principally owned and operated with a local viewpoint and orientation. The enormous differences that can exist within any bank's definition of its market are difficult to bridge in any effective or coherent way as geographies expand.

The same is true of credit product offerings. Larger banks have large product suites and it's inevitable that in the urge--indeed the economic necessity--to produce interest income, size tends to predominate. It's arguably easier and more "efficient" to make ten loans of \$1 million each than 100 loans of \$100,000 each.

These natural differences of scale produce very different community impacts. Consider the differences in the way commercial credit is underwritten and delivered. We've mentioned many times of the trend toward credit scoring of borrowers' behavior and the apparent processing efficiencies of centralizing underwriting, especially among those market participants who operate over several and diverse geographies. That's a natural and some would say an inevitable consequence of size. "Big begets big" argue the community bankers, while "small" is overlooked as being inefficient or non-economic.

Outcome of the struggle

Who are the winners and who are the losers? This is a real and urgent question.

Like so many questions of economic consequences, the answer is an unequivocal "it depends."

A well-oiled, "big bank" operation for generating business loans benefits the shareholders, who reap the benefit of lower costs and higher revenues. But what of the business owners in any marketplace served by very large banks? Do these market participants get the same level of attention and access that the larger borrowers do? Does the automated scoring of applicant behaviors trump the individual assessment and knowledge of the local lender applied to the local market place?

There's probably room for both approaches but it seems that the mega banks enjoy some advantages not fully accessible by their community bank counterparts. This is conspicuously so in the cost of lendable funds, for example.

Efficiency versus efficacy

There's very little if anything that a very large bank can't do cheaper or in greater variety than its smaller community bank competition.

But what are the costs to the community?

Is the flow of credit to all participants as robust, given the presence of one or more mega banks compared to a market characterized by the absence of very large players?

There may be some studies somewhere that purport to give answers to questions like this but they wouldn't be very persuasive to most community bankers.

Community banks and bankers have increasingly claimed the high ground in the underwriting of business credit. Their values emphasize personal knowledge of the market; personal evaluation of the character and integrity of each borrower; and an understanding of the need of the availability of local credit for the continued prosperity of the community.

And their values also include a sense that each local market place is a semi-closed environment nurtured primarily from within by banks whose owners and employees understand that they prosper in direct proportion to their local involvement.

Why understanding independence means understanding our future

Now, to return to our original query, regarding independence...

Independence to a community banker is a positive affirmation of a commitment to a big idea applied in small-sized pieces to the benefit of a defined and definable whole.

It is its own ecology in a way that affirms the strength and vitality of local businesses associated with local lenders with everyone pulling in the same direction for a similar result.

It's an idea as old as this nation itself. And we as independent bankers need to get better at explaining it and its importance to our customers before it's lost to future generations of citizens and business people.

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and has been a frequent speaker in ABA's Bank Director Telephone Briefing series. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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