AN EVALUATION OF THE POLICIES OF THE COMPTROLLER OF CURRENCY, MR. JAMES J. SAXON, REGARDING THE MERGER OF COMMERCIAL BANKS

by

KHALIDA HAQUE

A THESIS

Presented to the Department of Economics
and the Graduate School of the University of Oregon
in partial fulfillment
of the requirements for the degree of
Master of Arts

August, 1964

APPROVED ______________________
Barry N. Siegel
(Adviser for the Thesis)

VITA

NAME: Khalida Haque

AGE: 29

DATE OF BIRTH: December 27, 1934

PLACE OF BIRTH: Bhopal, India

EDUCATION: a. Primary School:

Hamidya Primary School, Bhopal, India

b. High School:

Islamia Girls High School
Lahore, W. Pakistan - Graduated 1949

c. College:

To: Ali Nasir

Presentation Convent College
Sargodha, W. Pakistan - 1949-1951

Lahore College for Women
Lahore, W. Pakistan - 1951-1953
Graduated Degree of B.A. in 1953

Fields of Specialization:
1. History
2. Political Science
3. English
4. Economics

University of the Punjab
Lahore, W. Pakistan - 1953-1955
Granted M. A. Degree in 1955

Fields of Specialization:
1. Monetary Theory
2. Public Finance
3. History of Economic Doctrine
4. Economic Development in Underdeveloped Countries.

JOB EXPERIENCE: Junior Accountant
State Bank of Pakistan
Lahore, W. Pakistan - 1958-1962

VITA

NAME: Khalida Haque

AGE: 29

DATE OF BIRTH: December 27, 1934

PLACE OF BIRTH: Bhopal, India

EDUCATION: a. Primary School:

Hamidya Primary School, Bhopal, India

b. High School:

Islamia Girls High School
Lahore, W. Pakistan - Graduated 1949

c. College:

Presentation Convent College
Sargodha, W. Pakistan - 1949-1951

Lahore College for Women
Lahore, W. Pakistan - 1951-1953
Graduated Degree of B.A. in 1953

Fields of Specialization:

1. History
2. Political Science
3. English
4. Economics

University of the Punjab
Lahore, W. Pakistan - 1953-1955
Granted M. A. Degree in 1955

Fields of Specialization:

1. Monetary Theory
2. Public Finance
3. History of Economic Doctrine
4. Economic Development in Under-developed Countries.

JOB EXPERIENCE: Junior Accountant
State Bank of Pakistan
Lahore, W. Pakistan - 1958-1962

LEISURE INTERESTS: Urdu Literature, Swimming, Foreign Travel, Politics and Liberating Pakistani Women

TABLE OF CONTENTS

LIST OF TABLES

LIST OF CHARTS

CHAPTER I

MERGER MOVEMENT

Importance of Movement

Commercial banks play a very important role in a country's economy. They are the heart of the financial structure, since they have the ability, in cooperation with Federal Reserve Banks, to add to the money supply of the nation and thus create additional purchasing power. This characteristic sets commercial banks apart from other financial institutions. Although banks create no new wealth, their lending, investing and related activities facilitate the economic process of production, distribution and consumption.

A multiplicity of laws, rules and regulations shape bank activities. There are two types of banks: National and State banks. National banks are incorporated under Federal Law and are regulated by the Comptroller of Currency. About one-third of commercial banks are National banks; they have more than half of total assets and deposits. The Comptroller examines National banks, allows charters, consolidations and mergers. His policies play a great part in forming the financial conditions of the country. He is an important figure in Finance.

The merger movement in banking in the last decade, due in part to the lenient policies of comptrollers of currency, has become a controversial issue. In addition to other objections, the Antitrust Department holds the view that the merger movement lessens competition and increases concentration. In our discussion, we will examine the effect of the merger movement on competition. Mr. James J. Saxon, Comptroller of Currency, in his term of office from November 16, 1961 through April 19, 1963 approved 139 mergers, consolidations and purchases of assets. He is in favor of expansion of banks -- whether through new charters, new branches, mergers or holding companies.

The issues of banking concentration and monopoly were once brought to the forefront of political discussion through the deliberations of the Congressional Committee on the Judiciary and the antitrust action by the Board of Governors of the Federal Reserve System against the Transamerica Corporation.[1] The Committee reported that the problem of bank concentration is an urgent one, because "concentration of financial resources and credit facilities are even more ominous to a competitive economy than concentration on an industry-wide basis."[2] Monopoly power and the consequences of monopoly are widely held to be inimical to the public interest.

---

[1]The Transamerica Corporation was charged on June 24, 1948, with violation of Section 7 of the Clayton Act by acquiring controlling stock interest in various independent banks, which were at the time of such acquisition in competition with one or more of the banks already controlled by Transamerica Corporation.

[2] Bank Mergers and Concentration of Banking Facilities. Staff Report of Subcommittee No. 5 of the Committee on the Judiciary, H. R. 82nd Congress, 2d Sess. (1952).

It is the purpose of this study to develop the economic analysis of the merger movement in this regulated industry. We will also study, in addition to the regulations imposing different restrictions of entry and restrictions by State laws, other means by which the industry could be expanded to meet the needs of the community.

Definition of the Terms

No sound discussion can take place unless the meanings of the basic terms are explained. It is desirable at this time that we supply definition of our major terms.

Merger:

Much could be written to define the word "merger" and to distinguish between it and words that have similar connotations. Warren G. Hayes devotes more than two pages of his thesis to a discussion of this point.[1] His conclusion is that, for many purposes involving consolidation procedures, there is no need to distinguish between mergers and consolidations.

Another writer, in analyzing the growth of corporations, has this to say:

> External growth may take place by the purchase of assets, by consolidation, by merger, by lease or by holding company device. Technical differences between these types of external acquisition are ordinarily observed. In consolidation all the participating firms lose their identity

[1]Warren G. Hayes, A Study of the Procedure in the Consolidation of National Banks, Graduate School of Banking, 1955, pp. 9-12.

and a new firm is created. In mergers, the absorbing firm retains its identity. In holding company arrangements, the parent and each subsidiary retain their separate identities, but usually not independently of managerial control. Hence, external acquisitions may include a wide variety of forms. In general usage, "merger" covers all these types.[1]

The term "by lease" as used by Weston above, does not appear applicable to banking. There is also disagreement as to the propriety of treating the holding company device as a means of merging. Because by holding company device each subsidiary retain their separate identity and thus could not enjoy the merger benefits. For the purpose of this thesis, "merger" will include legal merger, the purchase of assets, the assumption of deposits, liabilities and consolidations.

Unit Banking:

By unit banking we mean banking services offered by a single bank corporation. A unit bank operates with a single office or place of business; it is not controlled by another bank or by a corporation or individual that controls another bank.

Branch Banking:

By branch banking we mean that a single banking business conducts banking operations at two or more places. The branches are controlled from one location referred to as head office. The head office and all the branches are controlled by the same board of directors and owned by the same stockholders.

---

[1]J. F. Weston, The Role of Merger in the Growth of Large Firms (Berkeley: University of California Press, 1953), p. 3.

Chain Banking:

When two or more banks are controlled by one or more individuals, other than a holding company, the situation is referred to as chain banking.

Changes in Commercial Bank Structures

United States banking structure has changed considerably since the 1920's. In 1920 there were nearly 30,000 commercial banks in the United States, with 31,500 offices. Since then both the number of banks and banking offices have declined. After reaching a low point in the 1940's, the number of banking offices has had an upward trend; many banks have expanded their operations by establishing new branches when permitted by State banking laws. In contrast, ever since the 1920's the number of independent banks has declined with amazing consistency. In 37 of the 42 years between 1920 and 1962, the number of banks has dropped. Today there are slightly more than 13,400 banks.[1]

---

[1]See Tables 1 and 2, pp. 6 and 7.

TABLE 1

NUMBER OF BANKING OFFICES, BANKS, AND BRANCHES IN THE UNITED STATES FROM 1953-1962

Year	Number of Banking Offices	Number of Banks	Number of Branches	Population per Banking Office
1953	19,981	14,024	5,957	7,923
1954	20,324	13,881	6,443	7,931
1955	20,818	13,756	7,062	7,892
1956	21,420	13,680	7,740	7,809
1957	21,979	13,607	8,372	7,748
1958	22,608	13,540	9,068	7,653
1959	23,276	13,486	9,790	7,583
1960	24,103	13,484	10,619	7,467
1961	24,943	13,444	11,499	7,342
1962	25,930	13,439	12,461	7,166

Source: Annual reports of Federal Deposit Insurance Corporation and Statistical Abstract of the United States.

The slow decline in the number of banks in 1940 was accelerated by the revival of merger activity in the 1950's. Between 1953 and 1962[1] there were 1,661 mergers. The movement gained speed in 1953. There was a net decline of about 670 banks over the decade. Though the decline in number of banks was not as great as it was in 1920, it is still of concern to many. The number of banks declined only four percent from 1953 to 1962, compared with an eighteen percent decline in the 1920's.

In the 1920's, the number of banks per person in the United States fell twenty-five percent; from 1953 to 1962, eighteen percent.

Banking structure, then, has changed before; current developments should be kept in perspective. Our case study of the merger movement, therefore, will begin with a brief consideration of the background against which current changes are taking place. We shall then look at the nature of the changes, particularly the characteristics of the banks involved, and reasons for the movement's gaining speed during the last decade. Finally, we shall discuss some general principles to use when examining the bank movement.

---

[1]See Table 3, p. 9.

TABLE 3

NUMBER OF ABSORPTION, CONSOLIDATION, AND MERGERS, VOLUNTARY AND INVOLUNTARY 1953-1962

Year	Total	National Banks	State Banks	Non-member Banks	Non-insured Banks
1953	115	63	18	28	6
1954	207	93	26	83	5
1955	231	124	38	60	9
1956	189	75	39	69	6
1957	156	52	32	63	9
1958	150	65	30	52	3
1959	167	71	30	62	4
1960	129	49	24	53	3
1961	137	49	29	57	2
1962	180	80	35	61	4
Total	1,661	721	301	588	51

Source: Annual Reports of Federal Deposit Insurance Corporation.

Economic Environment of Commercial Banks

Banks, if they are to survive, must adapt themselves to their environment. As the United States economy has changed over the years, so has the banking structure. During approximately the first two decades of this century, the picture is one of "extensive" expansion in banking. This was a period of economic growth. Farming was especially prosperous.

Most of the banks of this period were unit banks. Branch banking had not been uncommon before the Civil War, but with the establishment of the national banking system, branches were generally frowned upon.

While banks were heading in one direction, various strong forces in the economy were heading in the other. People were moving to large cities and business concerns were merging or in other ways building huge organizations to produce and distribute goods on a mass basis. The banking structure was due for change.

Beginning in the early 1920's, and ending with the banking holiday, March, 1933, banks suffered through their next phase -- a period of retrenchment. The number of banks was cut in half as a result of three main things: fewer new banks being established, failure, and merger. Earnings were poor and there were too many banks.

Loans were the major commercial bank asset during this interwar period. But during World War I, banks had bought government bonds on a large scale, and after the war their holdings of bonds of other types outgrew their loans. Within the loan portfolio, the most rapid growth was in loans on securities (helping to finance the great stock market boom of the 1920's) and on real estate. By 1929, when production, employment, and prices made their sharp downturn, old fashioned loans were no longer dominant.

We shall never know to what extent the mergers in the 1920's eased or aggravated problems. Many mergers were outright lifesaving operations, strong banks taking over weak ones. Many mergers were made in an effort to better meet the needs of the economy, to increase lending capacity, and to acquire branches in growing areas.

From 1933 to 1935 a number of new banks were established to meet the needs of areas left without banks;[1] and again in the mid-1940's new banks were set up in response to the expansion of the economy in World War II. But, generally speaking, the number of new banks has held fairly steady.

Failure and mergers have been very few, particularly when compared to the 1920's.

The most significant development of the 1940's has been the steady growth in number and importance of branches, the two important factors being economic development and legal provisions. In many ways the centralization movement in the economy at work earlier in the country is being reversed; people have been moving to

---

[1] "Changes in Banking Structure, 1953-1962," Federal Reserve Bulletin, (September, 1963), p. 1191.

suburbs and industry is decentralizing. Laws have been further liberalized facilitating mergers, the creation of new branches, and the conversion of chain and group banking systems to branch banking systems.

Mergers in the last decade differ from the mergers of the Twenties, which were life-saving operations. Mergers during the 1953-62 period were mostly in larger cities and, on the whole, did not make the services of big banks available to small banks. In many cases they were inspired chiefly by profitable prospects of a trust or securities business or simply by a desire to be bigger, in order to be of optimal size and enjoy larger scale economies.

Causes of Merger

There are two parties to the merger -- the acquiring bank and the absorbed bank. In attempting to evaluate the relative importance of the various causes of mergers, we are primarily concerned with the initiating causes. The major initiating causes can originate either with the acquiring bank or the absorbed bank.

The principle motives for bank mergers are discussed below:

1. on the supply side -- absorbing bank
2. on the demand side -- acquiring bank
3. on the regulator's side -- Comptroller of the Currency.

1. Management problems are often cited as a cause of bank mergers. Professor Marcus Nadler, for example, has indicated that bankers must attach suitable persons to avoid managerial diffi-

culties; failure to do so "will accelerate the merger movement among banks."[1] The 92nd report of the Comptroller of the Currency suggests that problems of top management have been among the most important reasons. In many banks the advancing age of officers and failure to provide suitable replacement has resulted in merger. In others the managing owners have wished to retire from the banking business. There are differences of opinion regarding the weight which should be assigned to management problems in causing bank mergers. A study of bank mergers in the Third Federal Reserve District concluded in 1955 that: "As a conservative estimate. . . management problems have played a part in bringing about at least one half of the mergers included in our study."[2] On the other hand, the then Comptroller of the Currency, Mr. R. Gidney, has stated that the problem of aging management with no suitable replacement available is "far from being the primary cause" of recent mergers.[3] Management problems would appear to be sufficiently unambiguous to permit direct testing of their importance in causing mergers; in fact they are not. More then one consideration is usually involved

---

[1]New York Times, June 4, 1952, p. 42.

[2]Federal Reserve Bank of Philadelphia, Business Review, January, 1955, p. 6.

[3]Comptroller of the Currency, Nineteenth Annual Report, 1952, p. 4. In his 1952 and 1953 Annual Reports, the Comptroller reported management problems as one of the six reasons for mergers involving National Banks.

in a bank merger.

Mr. James J. Saxon, Comptroller of the Currency in his recent interview with a member of U. S. News and World Report, stated that the lack of enough managerial talent is one of the reasons for a bank merger. However, "banks are realizing the necessity for bidding for the best men available."[1] It is, therefore, reasonable to conclude that the management problem may have contributed to the recent upsurge of mergers, but it is not the major initiating factor.

2. Higher costs and lower profits also help in accelerating the merger movement. Bank costs, earnings and composition are significantly conditioned by bank size and bank structure. Since the United States is still predominantly a unit banking country, bank size is employed as an important classifying variable.[2] Bankers and economists have emphasized the economies of large-scale operations and the savings in labor and other expenses that come with larger banking units as an explanation. There are substantial economies of scale in banking. Were the banking industry identical to a single product manufacturing firm the concept would be reasonably clear. But banking is a multi-product industry, and the major difficulty we will encounter here is the measurement of costs. Non-current transactions complicate cost determination. Even the

---

[1] U. S. News and World Report, November 25, 1963, pp. 90-93.

[2] D. A. Alhadeff, Monopoly and Competition in Banking Berkeley: University of California Press, 1954.

measurement of current expenses is not completely satisfactory, because certain non-current transactions often involve current expenses. Non-current transactions affect income taxes, since some current income (interest on municipal securities) is tax exempt. We face the same difficulty in defining or measuring the output of a bank because of the multi-product nature of the industry.

Lyle E. Gramley, in a study prepared for the Federal Reserve Bank of Kansas City, found the large scale economies in banking industry, which he attributed to "the advantages of large scale operation in banking are not adequately expressed in comparative net rates of return on assets . . . [but] associated with reduced risk of enterprise . . ."[1]

In discussion of costs of manufacturing the point is often made that economies of scale are due to size of plant rather than size of firm. The multi-plant operation in banking refers to branch banking -- which means lower cost with the increase of the size of banks.

The first study of bank costs to make extensive use of empirical data was Professor Alhadeff's Monopoly and Competition in Banking. He compared costs of California unit and branch banks of various sizes for the period from 1938-1950. In spite of the limitations imposed by the data, he was able to

---

[1]Lyle E. Gramley, A Scale Economies in Banking, Federal Reserve Bank of Kansas City, 1962, p. 59.

derive some interesting results. Alhadeff found that branch bank costs were higher than costs of the largest unit banks. They were lower than the costs of the smaller unit banks. As he states:

> Branch bank costs are actually higher than those of the largest unit banks. Even when interest costs are ignored in the comparison, the remaining costs of branch banks are at best only equal to those of the largest unit banks.[1]

A merger to create branches for the purpose of reducing costs is an unprofitable reason for merger, due to the fact that profitability varies with the particular measure of profitability employed.

Higher operating costs and lower earnings have not exerted systematic pressure upon banks to merge. Even though costs and profit pressure were important in actual mergers; the merged banks succumbed because of individual weaknesses, and not as representatives of their economic class.[2]

3. Prices or terms have been offered which the shareholders have found most attractive. These price terms have been a particularly strong factor because the stocks of many banks have a limited market and sell at prices below book value. The yield from dividends has not been very attractive, and this has adversely affected the market price of the shares. This has been caused not

---

[1] Ibid., p. 106.

[2] C. P. Alhadeff and D. A. Alhadeff, "Recent Bank Mergers," Quarterly Journal of Economics, 1955.

so much by poor earnings as by need to augment capital.

4. Small banks have joined forces in order to compete more effectively with nearby large institutions.

5. An analysis of earlier consolidation movements among banks ascribed an importance to lending restrictions as a motive for merger. This point has been described by Steiner and Shapiro:

> . . . bank mergers have been consummated in order to increase a bank's capitalization and deposits, thereby enabling the institution to furnish more adequate service to its customers. The growth in size of business enterprises increased the credit needs of these firms. Since the maximum unsecured loan to one borrower is limited to 10 percent of a bank's capital and surplus, an increase in the bank's capital base permits a larger maximum loan limit. The increased resources of the merged bank enable it to grant the larger loans made permissible by the increased capitalization.[1]

Similar, in reference to the current merger movement, it has been stated that ". . . banks have to keep pace with development of U. S. economy. If industrial agglomerations of capital get bigger, the banks serving them must do the same."[2] Clearly the increased lending limits which often accompany a merger must be listed as an advantage in weighing the merits of the proposed merger. But to what extent banks utilize their increased limits and serve the community's increasing needs, is still an unanswered question.

---

[1]W. H. Steiner and Eli Shapiro, Money and Banking (New York: H. Holt and Company, 1964), pp. 105-106.

[2]Business Week, February 12, 1955, p. 126. Views of J. Stewart Baker, Chairman of the Board, Bank of Manhattan Company.

Increases in a community's needs are not just an increase of one group, but an increase of all: large, medium, and small size borrowers. The large borrowers are usually few and enjoy an unlimited market. Medium and small borrowers, who have a limited market, can only approach banks in their immediate community. The banks in a given area could hardly justify a merger for the reason of better serving the community.

This would seem to support those who argue that banks have been most restricted by lending limits in competing for big customers with life insurance companies. The major loan competition between commercial banks and insurance companies is term loans. However, since banks have a comparative advantage over insurance companies in any form of lending as against investing, term loans are mostly negotiated by commercial banks. Indeed, term lending by insurance companies is often complementary rather than competitive with commercial banks. Term loans have been syndicated between banks and insurance companies, particularly when the maturity of the loan is greater than that desired by the bank. The insurance company then takes the longer part of maturity and the banks the shorter.[1] It is unlikely that the remaining area of genuine competition between banks and insurance companies, for the limited part of the banking system which is involved, is

---

[1]E. W. Reed, Commercial Bank Management (New York: Harper and Row, Publishers, 1963), p. 309.

important enough to explain the sharp increase in bank mergers during the period from 1953-1962.

Larger banks acquiring comparatively small banks, instead of large banks,[1] has been the chief characteristic of the merger movement in recent years. It would be more efficient and certainly more effective to merge two large banks directly, with a correspondingly sizable increase in capital. Since the pressure of lending limits is great on both, both parties would be impelled to seek each other out; thus the merger would be mutually beneficial. It is not denied that lending restrictions are important in individual cases. For the majority of the participating banks, however, the available data do not support the 10 percent hypothesis as a major initiating factor in the upswing of mergers.[2]

6. In many cases, local businesses or industrial concerns which were of major importance to a small town bank have been sold to large concerns which have their banking ties in big cities. In these cases the small banks usually receive a smaller percentage of the banking business of the concern, and sometimes find it advantageous to combine with a larger bank.

---

[1]See list of mergers, consolidations, and purchases of assets approved by the Comptroller of the Currency, Mr. James J. Saxon from November 16, 1961 to April 19, 1963, furnished by the Comptroller's office to the Committee on Banking and Currency, House of Representatives, 88th Congress, 1st Session. Conflict of Federal and State Banking Laws. 1963, p. 482.

[2]See Table 6, where it is evident that large banks are not the main merging banks.

7. Fringe welfare benefits and increased compensation available for officers and employees from the potential absorbing bank have caused management to back many mergers.

8. Uneven growth of different banks is also one of the reasons for the growing merger movement of 1953 to 1963. The banking system as a whole expanded tremendously during the period from 1941 to 1952. During this period deposits increased 240 percent.[1] This tremendous growth was not uniform for all banks in the system, however. In the economy as a whole during the expansion phase of the business cycle, different rates of growth in different sectors, or even within a sector, create structural maladjustment and thus instability. Similarly, in banking the very rapid expansion from 1941 to 1952 created stresses owing to uneven rates of growth of different banks.

It is also necessary to examine the motives of the banks considering these transactions -- the reasons why some banks have desired or considered it necessary to consolidate or merge with or purchase other banks. To some extent these motives overlap with the reasons given for the banks which are selling or merging their businesses into the continuing bank. The reasons we consider most important for the purchasing or acquiring of banks are:

A. The need to obtain banking offices in adjoining areas in order to enjoy to a fuller extent the benefits of volume

---

[1]Federal Reserve Bulletin, May, 1954, p. 477.

of retail banking; that is, serving a large number of individuals and small businesses through branches. Branch banks have shown a spectacular rate of growth in the past two decades. It is not necessary to review here the relative advantages of branch banking; it is sufficient for our purpose only to note the rapid growth of branch banking.

B. The growing importance of branch banking during the last two decades is producing a striking change in the formal structure of the commercial banking system in the United States. Many banks in branch restricted states merge to create branches. This eases the bank's most difficult current problem, that of a large migration of the population from metropolitan to suburban areas. This shift has affected the bank's earnings in two ways: first, its drain on deposits which raises the capital-deposit ratio; and second, the shift of the loan business of the depositors to the local banks of their domicile.

In branch restricted states it is difficult to get approval from regulatory authorities for de novo branches. In order to expand in these areas the banks will settle for a merger. Of all the mergers, consolidations and purchases of assets approved by the Comptroller of the Currency, Mr. James J. Saxon, during his tenure of office from November 16, 1961 through December 31, 1963, seventy-six percent of the mergers took place in states with limited areas of branch banking; nineteen percent in states with statewide branch banking; and only five percent in states which strictly prohibited branch banking.

C. The need for larger loaning limits and more available deposits to loan. This need has been caused by the general growth of industry as a whole.

D. Keen competition with other banks and non-bank financial institutions and the normal urge to excel in expansion, growth and earnings.

E. Desire for earnings. The above four factors are related to this point.

F. Professor Weston's reason for a bank's "desire to limit competition."[1] This point will be taken up in detail in the following chapter.

The foregoing are the reasons of banks for mergers. As banking is a highly regulated industry, the mergers cannot be effected without the approval of the Comptroller of the Currency in the case of national banks, the Federal Reserve Board in the case of state member banks, and the Federal Deposit Insurance Corporation in the case of non-member insured banks. The most commonly given reason for approval by regulatory authorities is public interest.

---

[1] J. Fred Weston's testimony in the Reports of the Committee on the Judiciary of the United States Senate, Corporate Mergers and Acquisitions. A staff study of the Subcommittee on Antitrust and Monopoly, 85th Congress, 1st Session.

Other reasons which indirectly influence mergers are summarized below.

1. Favor of expansion of the banking industry to meet the needs of an expanding economy. National banks are required to comply with the state laws of their domicile, and in branch restricted states the only means of expansion is a merger.

2. To create more banking offices in an underbanked area.

3. The Comptroller of the Currency's favorable attitude toward branch banking.

Summary

There are two parties involved in the merger movement, the acquiring banks and the absorbed banks. A few of the many reasons for the mutual benefit of the acquiring banks and the absorbed banks resulting from a merger are discussed above. The main purpose for acquiring banks to merge with small country banks is their desire for expansion to meet the needs of their depositors who are moving to suburban areas, to increase profitability by increasing deposits, and to acquire more market area for business. Reasons for external acquisition rather than internal growth for the accomplishment of business goals are:

1. New facilities may be acquired more quickly through mergers.

2. The desired facilities may be obtained more cheaply by purchasing the ownership stock of an existing company.

3. It is sometimes possible to finance an acquisition where it would not be possible to finance internal growth.

4. The development of new products and market areas may be accomplished through mergers, thereby avoiding the necessity for combating difficult competition in early stages of development.

5. Market control may be obtained more rapidly and with less risk through mergers than by internal expansion.

6. Competition could be limited by mergers rather than by internal expansion.

Mr. R. M. Gidney was appointed Comptroller of the Currency on April 16, 1953. Following his appointment the merger movement accelerated, bringing the subject of bank mergers to the attention of the Antitrust Department. The Antitrust Department brought suit to block several of the mergers approved by the Comptroller of the Currency. The rift between the Comptroller's office and the Antitrust Department resulted in the resignation of Mr. R. M. Gidney and the appointment of Mr. James J. Saxon in November, 1961.

Mr. Saxon also favors expansion of banks, whatever form it may take: new charters, new branches, mergers, or holding companies. He approved 80 mergers in 1962, as compared with Mr. Gidney's average of 74. Mr. Saxon expressed the need for expansion in his address before the National Credit Conference of the American Banker's Association, Chicago, Illinois, on January 22, 1963:

> As our economy has grown, it has become increasingly evident that the commercial banking system occupies a central role in its progress . . . . A deficiency in that financial mechanism will critically affect the role of our economic growth.

As new branches and new charters are restricted by state laws in most of the states, the merger device is being used to expand the banking industry.

The following two chapters will be devoted to the device used by Mr. Saxon and its effect upon the financial market and thus the economy as a whole.

CHAPTER II

COMMERCIAL BANK MERGERS AND COMPETITION

Introduction

The upswing of the merger movement since 1953 aroused the interest of the Justice Department. In their opinion, the Comptroller of the Currency has been approving bank mergers too freely. The Justice Department for several years has sought to obtain from Congress specific authority which would permit it to institute antitrust proceedings to enjoin bank mergers. Finally a law was enacted in May, 1960, the Bank Merger Act, which gave the Antitrust Division of the Justice Department an advisory role in bank merger cases. The banking agency authorized to approve a contemplated merger must request from the two other Federal banking agencies and from the Justice Department a written opinion on the competitive factors involved. The law requires the banking agencies to consider not only the competitive factors, but six other banking criteria, such as history, condition, capital, management, and the community's needs, whereas the Justice Department is required to report only as to the effect on competition. The law of 1960, therefore, did not give the Justice Department the final word in bank mergers. Even though the Justice Department's report on the competitive effect is strongly adverse in any given case, its views may be overridden. The Antitrust Department was vigorous in applying the antitrust laws and stopped several mergers approved by the Comptroller. The courts in many instances had to decide whether competition was the final criterion.[1]

Competition

There are no precise definitions of competition and monopoly. Neither economics nor law has produced a uniform classification of competitive and monopolistic situations. There are well accepted concepts of the two conditions in their theoretical forms. However, none of these fits the real world. One of the commonly used definitions of competition in the theoretical and analytical literature is pure competition. According to Chamberlain, who established the modern formulation, pure competition in an industry is characterized by a large number of buyers and sellers who deal in homogeneous, or standardized commodities. These buyers and sellers have no influence on selling prices. Any individual can easily enter the market as a seller or a buyer, and he can have the market just as easily without any outward sacrifice. All buyers and sellers have equal knowledge of current market conditions -- prices paid, volume and cost. No buyer-seller loyalties exist. No supplier has any trade advantage through reputation, patents,

[1]The legal aspects will be discussed in Chapter III in detail.

or financial and family connections. The world of pure competition is completely deterministic. Factor prices and product prices are determined exogenously to the firm. Profit levels are zero and all firms in a given industry tend to be of the same size.

The opposite pole is equally clear. The perfect monopolist is the only one seller in a market, and a monopsonist is the sole buyer. Competing with no one, the monopolist has full freedom of choice over his price. After estimating his volume of sales at various prices and his total costs for such volume, the seller sets the price which will give him the largest profit attainable.

These concepts were developed in traditional economic theory. They were not conceived as literal descriptions of the economy.[1] Rather they were used to support the thesis that a competitive economy would allocate the use of resources most efficiently. They were employed to show that such an economy would be most sensitive to consumer demands and would attain the greatest consumer satisfaction.

Later came empirical studies of industrial practices, which revealed the shortcomings of these theories and pointed up the need for changes in theoretical analysis. Modifications were developed, still within the framework of a general, rounded

---

[1]"We have not and probably never had perfect market competition of the kind described by the classical economists . . . ", Corwin D. Edwards, "Preserving Competition vs. Regulating Monopoly," American Economic Review, 1940, pp. 164-170.

theoretical pattern. "Imperfect competition"[1] was offered by Joan Robinson as a variation of original theories. Professor Edward H. Chamberlain developed the theory of "monopolistic competition"[2] to accommodate such forces as the market advantage of brands in a competitive framework. These and other works produced broad market theories in the tradition of previous economic theory. However, they suggested the desirability and possibility of bringing economic analysis closer to the market place.

A basic weakness of the theory of pure competition is its unrealistic assumption of homogeneous (or standardized) products. No matter how alike some products may appear, if they differ in the minds of the consumers they are different. Each firm will have a partial monopoly of its own product, so that no matter how many sellers there may be the sales curve facing each seller will not be perfectly elastic. This is not to say that because each seller is a monopolist he will necessarily make monopoly profits by restricting his output and selling at a higher price. There can be many firms offering closely competing substitutes. A large number of closely competing products will insure a much smaller share of the total market than if there were only a few firms or if substitutes were more remote.

---

[1]Joan Robinson, The Economics of Imperfect Competition (London: Macmillan and Co., Ltd., 1938).

[2]E. H. Chamberlain, The Theory of Monopolistic Competition (Cambridge: Harvard University Press, 1939).

Mere number, however, can never alone reveal how much rivalry exists or how effective competition is. For the rivalry that counts is the economic rivalry that takes place in markets, i. e., the loci of space and time where buyers and sellers meet.

Market

The finding of monopoly or competition always hinges on the definition of the "market," a concept difficult to define. It includes those sellers who compete with one another in offering a specific product to a given group of customers. However, market can be defined narrowly to exclude many sellers who transact business on the fringe of the market; when such a definition is used, the market may seem to be dominated by only a few sellers. If, on the other hand, the market is defined broadly to include sellers on the fringe, it will usually appear more competitive.

There are several kinds of fringe sellers who might be thought of as "not quite" or "just about" belonging to a particular market. There are those, first of all, whose products are slightly different. [1] In most markets, each seller's product tends to be a little different, if only because of different brand names and trade marks. The practical question which frequently arises is how to distinguish between products that purchasers feel they can easily

---

[1] Joe S. Bain, Industrial Organization (Berkeley: University of California, 1959), p. 8.

substitute for one another -- and which therefore are competitive -- and products which they do not feel are close substitutes.

Another kind of line must frequently be drawn. Some producers may be geographically remote from the principal market. Their remoteness may reflect the high cost of transporting their product. It follows that these producers are only partially, if at all, competitive with others even though they may sell identical products.

The market is the crucial concept in evaluating the forces of competition. The effective rivalry a firm faces comes from other firms that produce the same or similar products and sell to the same group of customers. It is in the crucible of the market that the forces of competition must be examined.

Banking Market

Before we proceed to the discussion of competition in the banking industry, it is helpful to define the market structure of commercial banks with the following classification:

1. Supply side
    - A. Alternative sources of supply.
    - B. Differentiated products.
    - C. Problem of entry.
2. Demand side
    - A. Alternative sources.
    - B. Geographical location.
    - C. Price determination.

A. Alternative Sources of Supply

The traditional and semi-unique products that banks supply to their customers are short-term business loans. Commercial banks, however, are not the only institutions which supply short term business credit to the community. Short term business credit is supplied also by commercial finance companies, businesses which extend trade credit, the Small Business Administration, Federal Reserve Banks, and, in some cases, by private individuals. Lending by private individuals is a source of funds to small business. Also, it does not exist in a formal institutional framework. Therefore, loans by private individuals cannot be regarded as a substitute for bank loans by the majority of business borrowers.

Federal Reserve Banks are qualified to make limited industrial loans only in cases where the industry is needed but where it is not possible to obtain requisite financial assistance. This restricted lending activity of Federal Reserve Banks cannot qualify as a suitable substitute to the ordinary business loan of the commercial bank.

The Small Business Administration is also not an important supplier of business in relation to commercial banks. They only supplement their resources to commercial banks to extend to their customers in return. Small Business Administration is not competitive but complementary to commercial bank short-term business loans.

Trade credit is undoubtedly an important source of credit to small business. It is commonly granted by wholesalers and manufacturers to retailers and other distributors and by suppliers to processors who themselves obtain bank credit terms not directly available to the small business.

Specialized finance companies are insignificant alternative sources of supply for most borrowers.

Trade credit is the only important example of an alternative source of supply of short term bank business loans which can meet at least some of the tests of a reasonable substitute. Trade credit is at best only a highly imperfect substitute for bank loans and under most conditions does not constitute a competitive alternative source of supply.

Commercial banks, therefore, compete only among themselves and the market of these different banks is highly localized.

B. Differentiated Products

As was mentioned earlier, no matter how alike some products may appear, they differ in the minds of customers. There may be more than one bank in a community, but some customers are bound to those bankers with whom they have historically transacted business, and their credit facilities and services may be unique in the minds of the customers.

Sometimes bankers in a community specialize in different forms of credit. Some bankers mostly deal in mortgage banking, some in wholesale or retail banking, some in consumer credit, and others in business credit, etc. All of these banks are engaged in the lending business, but each of them has a partial monopoly of its own product. Even if two or more banks in a community deal with the same type of business or product, their service or banker-customer relationship makes their product different in the minds of customers.

C. Problem of Entry

The government relies heavily on business competition to protect the public interest in most economic matters. This policy is based on the view that "under a free enterprise system, competition acts as a constant safeguard of the public interest . . . and the need for Government regulation and control is minimized, where competition thus automatically safeguards and promotes the public interest."[1] In the case of banking, however, public policy seeks to protect the public interest by preventing undue competition. To enhance the safety of the banking system and to minimize bank failures, public policy restricts entry into banking. Restricted entry limits the number of competitors in the product market. Entry restriction has a non-uniform impact on the markets for loans. Large, medium, and small sized borrowers constitute important, partially separate submarkets of the banking industry.

---

[1]M. Nadler and J. Bogen, The Bank Holding Company (New York: Graduate School of Business Administration, New York University, 1959), p. 40.

Entry restriction is completely ineffective for business loans to large borrowers.

The large borrower deals with the national market and the largest banks dominate this market,[1] but many small banks directly or indirectly participate in the market. The large number of suppliers assures effective competition. Entry restriction cannot significantly alter the character of bank rivalry in this market. The credit extended by a commercial bank depends on the amount of its deposit and only to a limited extent on the amount of its capital. New banks might secure a large paid in capital, they could not immediately attract adequate deposits to become important suppliers in this market. Accordingly, entry barriers are unnecessary to keep new banks out of the national market. As far as medium sized borrowers are concerned, entry barriers restrict some efficient banks from this market. New banks through superior efficiency might eventually grow large enough to enter this market or may eventually enter the larger, national market. In the small size borrowers' market, the banking structure is largely oligopolistic or quasi-monopolistic in character. Entry restrictions in this market have an adverse effect on competition, as more and more banks in this market will increase the rivalry among sellers

---

[1]For the purpose of explaining the effect of entry restrictions on banking market, we made use of the classification developed by Professor Alhadeff in which large, medium and small borrower markets are distinguished.

and small borrowers will have more alternative sources of loanable funds to approach.

Restriction of entry on the commercial banks' raw material market is also ineffective. There are two types of raw materials:

1) Demand deposits. Here commercial banks face no inter-institution competition; they compete only amongst themselves. In this market entry would not have any effect, as the law prohibits interest on demand deposit and there would be no question of price competition; rather it would help in increasing service competition, resulting in more efficient banks.

2) Savings or time deposits. Public policy to prevent undue competition sets ceiling rates on time deposits with the result that depositors have found savings and loan shares almost perfect substitutes for commercial bank time deposits. Entry in this market would only enhance the sources available to the public and would have no effect on competitive aspects of the market. This ceiling rate on time deposits, however, failed to protect commercial banks from very vigorous competition by savings and loan associations.

If the level of prices charged by existing banks is high enough and there is no restriction to the entry, there is incentive for new banks to enter the market. Fear of new entry can lead existing banks to charge less than their market power would allow. In this way low barriers to entry can be important factors in producing more competitive results, even if, over a long period of time, actual entry is small.

The banking industry of the United States should be allowed to operate as freely and competitively as all the elements of the free enterprise economy that it serves and of which it is a part. The restrictions on branch formation and on new entry seem to disregard the workings of the free market. The weight is usually given on the criteria of "convenience and needs of the community," and to many banks these criteria may lead to undue competition and thus to failure of some banks, considered to be a community tragedy. We do not know, hoever, what weight is given to the initiative and judgment of those private individuals who stand waiting and willing to risk their capital and reputation in the undertaking. It is odd that bankers, who give advice to businessmen, are themselves restrained from acting on their own advice, and that banks which furnish the lubricant for all other businesses to grow and expand are themselves impeded from growing at a rate consonant with the growth of the economy.

2. A. Alternative Sources of Supply

As we have discussed earlier regarding alternative sources of supply we want here to see whether a prospective borrower who wants to negotiate a loan and is dissatisfied with the price or term of sale offered by one bank, or is denied a loan by one bank, can turn to another bank in his community. In a limited sense, the natural market area of a bank is the city in which it is located. All but the largest borrowers will typically borrow funds from banks in their respective cities or towns.

Metropolitan areas usually have more than one bank for the customer to approach. However, in a small community there are still many cases to be cited where we have only one bank.

In a recent study, made by Dean Carson and Paul Cootner, "The Structure of Competition in Commercial Banking in the United States," it is found that the one bank town is prevalent in the United States. It has been estimated that some 11,000 communities are served by one commercial bank; these comprise 45 percent of all banking offices in the United States. In addition, of all communities in the United States that have at least one bank, half are one bank towns. In these towns reside approximately 40 million people. [1]

In areas of more than one bank, the customers still have limited choice, as these banks are usually specialized in one type of business to enjoy partial monopoly of their own product.

B. Geographical Location

Borrowers in a somewhat arbitrary way are geographically

---

[1] D. Carson and P. Cootner, "The Structure of Competition in Commercial Banking in the United States," in Private Financial Institutions, a series of research studies prepared for the Commission on Money and Credit, (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1963).

limited. The large number of banks scattered throughout the United States, 13,400, is still significant despite the recent declines. These banks are not all competitive with one another in any meaningful sense. These banks transact most of their business in a patchwork quilt of small local and regional areas. In any one area, a bank tends to be isolated from the rivalry of other banks located in other areas.

There are several principal reasons for this. Bank depositors are generally limited by the cost of inconvenience to banks in the immediate vicinity of these daily journeys from home to work and back home again. A bank borrower whose principal asset when he goes to borrow is his character, is frequently limited by his friendship and acquaintance with local bankers.

While it is difficult for many bank customers to go to banks outside their local area, it is often impossible for a bank outside the local area to go to the potential customer. Banking offices, even of national banks, are confined within state borders and subject to state laws. There are 51 jurisdictions, each with a different set of banking regulations. In practice this means that a bank in California may not open a branch in any other state; a bank in Pennsylvania may not open a branch in a county outside those contiguous to the county in which it has its main office; and a bank in Illinois may not have any branches at all. The relative immobility of both banks and many types of bank customers serves to break up the United States into a series of geographic sub-areas.

The geographic limit of the market is not necessarily the same for all in a given locality. Some, perhaps most, will be restricted to local sources of credit. Others may have broader and more distant alternatives. We may say that a bank may deal with locally limited customers, regionally limited customers, and geographically unlimited customers.[1] By dealing in different markets, it may be able to exercise monopoly power in some and may have to compete vigorously in others, i.e., the possibility of price discrimination for services rendered is often present.

C. Determination of Prices

An analytical treatment of the commercial market must include information of determination of price and its effect on prospective customers. The degree of freedom possessed by a bank in determining the amount of service charges which it will attach to checking deposits and its freedom in determining the rates of interest which it will pay for time and savings deposits (of course within the limit imposed by Regulation Q, the legal prohibition embodied in the Banking Acts of 1933 and 1935, which set a ceiling -- now 4 percent -- on the commercial bank saving rates) depend upon the elasticity of the supply of such deposits with respect to the interest rate. This elasticity of supply in turn depends largely

---

[1]D. A. Alhadeff, "Bank Mergers: Competition versus Banking Factors," Southern Economic Journal, January, 1963.

upon the alternatives available to depositors. Several factors affect the availability of these alternatives: (1) the size of individual deposits, and (2) the degree of superiority of the bank's prestige and of its location and the number of its competitors.

Individual banks also possess a degree of freedom in determining the interest rate to be charged on their loans to customers.[1] To each bank the demand curve for its loans does not appear to be a horizontal line at the ruling market rate. In fixing rates on loans each banker encounters wide variations in the elasticities of different customers' demands for loans from him. Among large borrowers who deal in national markets, demands for loans at any bank are usually highly elastic. On the other hand, small borrowers who are restricted to local markets may have an inelastic demand for loans.

The wide differential in the elasticities of different customers' demands for loans and supply of deposits at an individual bank makes rate discrimination possible. The interest rate charged or paid varies by only a small amount, but discriminatory practices of banks are not confined to the interest rates on loans and deposits. A bank may lower the actual cost of the loan by rendering free services or by computing interest in a manner more favorable to

---

[1]In most of the state usury laws set the maximum rate banks can charge for loans. The freedom banks have in these states are within the prescribed rate by law. E. W. Reed, Commercial Bank Management (New York: Harper and Row, Publishers, 1963).

the customer. On the other hand, it may raise the cost of the loan by computing interest in a way unfavorable to the customer by requiring maintenance of a large deposit balance,[1] by exacting a fee for granting the loan, or by levying a charge ostensibly to cover the cost of credit investigations. These practices make the actual amount of rate discrimination greater than would be indicated by nominal interest rates. Only the borrower in a strong competitive position can refuse to pay extra charges or carry large deposit balances.

Banks and Competition

The above discussion of the market structure of banking reveals that the forces of competition in the market are complicated by the unique characteristics of banking. These special characteristics tend to veil the true extent of inter-bank rivalry.

As already mentioned, banks deal in many markets. The extent of their involvement means that we must study the numbers, sizes, and locations of financial institutions, not only commercial banks, in the sale of a variety of products to many different classes of customers. In reaching decisions, we cannot simply determine the intensity of competition in one product market; for we are

---

[1] J. J. Balles and D. A. Eastburn, "Bank Lending Policies in Period of Monetary Restraint," Money and Economic Activity: Reading in Money and Banking, (Boston: Houghton-Miffin Company, 1961).

concerned with the intensity faced by the institution as a whole.

Regulation tends to conceal the potential as well as limit the actual forces of competition in the market. All states regulate new entry into the market. Branching is also regulated and all states prohibit banks from having branches that straddle state lines. A market might potentially be highly competitive and yet show little evidence of this rivalry because of supervisory policies established to meet other objectives.

There are other ways, in addition to looking at the structure of banking markets, however, to observe the forces of competition. We expect effective competition to result, for the most part, in certain kinds of performance; we expect the lack of competition to result in a different kind of performance. For example, we would normally expect competitive sellers to charge lower prices and have smaller profits than non-competitive sellers. But in banking markets, no matter how intense the rivalry, the extent of these differences are restricted in various ways. Regulations and the character of the business are great homogenizing forces that make it difficult to distinguish between competitive and non-competitive results.

In most states, usury laws set the maximum rate banks can charge for loans. Federal regulations prescribe maximum interest rates on time deposits and prohibit the payment of interest on demand deposits. Within the limits set by these regulations, monetary policy has an influence on the level of rates and on changes in rates in all financial markets; for the monetary authority has an influence over the total amount of banking resources through bank reserves.

There is still another reason why profit differences between competitive and non-competitive banks might not reflect competitive differences: while banks, like other enterprises, seek profit, they have higher liquidity requirements than most; they have obligations to their depositors as well as to their stockholders.[1] It is conceivable that banks not really challenged by intense rivalry will have exaggerated notions of their liquidity requirements. These are the ones who can "afford to play it safe." In other words, the non-competitive bankers may choose to "rest easier" rather than "live better." The non-competitive banker may actually have lower profits than the competitive banker.

It is not in banking that the non-competitive banks are charging high monopoly prices; they are, rather, discriminating prices. Commercial banks cannot charge high monopoly prices because of several regulations. If a bank customer has access to many alternative sources of credit -- and this occurs when a bank is faced with competition -- his bank would have to charge him no higher price for credit than justified by costs, or run the danger of losing his patronage to a rival bank. If all customers have access

---

[1]R. I. Robinson, "Priority in the Use of Bank Funds," Money and Economic Activity: Reading in Money and Banking, (Boston: Houghton-Miffin Company, 1961).

to alternative sources of credit, all must be dealt with equally and in accordance to the costs of doing business with them; when, on the other hand, some have alternative sources and others do not, price differences and perhaps unjustified exclusion from credit become possible and at times profitable, as in the banking discussed above. This price discrimination is a serious injury to competition by hampering prospective businessmen whose deficiency is not incompetence or lack of foresight but only lack of alternative sources of credit. The extent of price discrimination is, perhaps, one measure of the degree of monopoly power in banking markets.

Competition may be measured in another way. It is conceivable that competitive banks are more responsive to changes in monetary policy than non-competitive banks. For monetary policy works through the supply of reserves a bank has at its disposal. Competitive banks would tend to adjust their prices -- interest rates -- quickly, perhaps automatically, to changes in supply conditions as well as to changes in demand; non-competitive banks might well react more slowly, particularly when the supply of funds increases and free market rates tend to fall.[1]

In raw material markets the competition is more inter-institutional than amongst themselves. In this market also, the intensity of rivalry cannot be measured because of greater dif-

---

[1]"Banking Structure and Reactions to Monetary Stringency or Ease," Monthly Review, Federal Reserve Bank of Kansas City, March-April, 1964.

ferences in regulatory treatment. This market among commercial banks is highly localized. The depositors because of their convenience will do business at the place of their domicile. Here again big depositors, accounts of big corporations having knowledge of the market will hunt for profitable yield.

Commercial banks face no inter-institutional competition in demand deposits, their unique service to the public's demand for a means of payment which comprise 51 percent of the total bank deposits. They compete only amongst themselves. The latitude of price variation here is highly limited. Interest payments are prescribed by law; the price inducement only rests upon reduction of service charges. Aside from the fact that the demand for deposit service is highly inelastic, such reductions are not feasible for many banks, small unit banks.

CLASSIFICATION OF DEPOSITS AT THE END OF YEAR 1962[1]
(in billions of dollars)

	Demand	Time
All banks	148.2	139.9
Commercial Bank	147.9	97.7
Mutual Savings Bank	.3	41.2

[1]Source: The Economic Almanac, 1964, The Conference Board Business Fact Book, p. 344-345.

Banks are not competitive even in the savings deposit market. Two major limiting factors exist here. First the Federal Reserve and Federal Deposit Insurance Corporation authorities enforce maximum allowable rates on such deposits. On the other hand, the earning capacity of assets based on time deposits, imposes a limit which a bank can afford to pay to depositors within the regulatory maximum. Because of the law covering yields on time deposit-based assets which have prevailed until recent years, many banks have been unable to raise deposit rates to the regulated level. Recent improvement in open market yields on investment assets has, however, resulted in a significant increase in time deposit rates. It would thus appear that the range of price competition in this area is strongly influenced by factors outside the control of individual bank competitors.

From the above discussion it can be seen that the banking industry is not in a purely competitive condition. In its product market small borrowers who could not go to regional or national markets face a monopolistic supplier position. In the case of intermediate borrowers, the banks may face a situation of monopolistic competition or of oligopoly and with large borrowers the situation could be highly competitive.

Merger and Competition

The increased number of mergers in this highly regulated and localized industry caused many to believe that the decline in the aggregate number of banks in the country is a definite trend towards monopoly and concentration. The number of banks is a very poor criterion for measuring competition. We have seen in Table 1 that, although the number of banks has decreased, the number of banking services is increasing and today the ratio of banks to population is higher than it was twenty years ago. It is very poor economics to conclude that a decline in the number of banks in the country necessarily and inevitably reduces the strength of competitive forces. Concentration ratios, even when derived for the relevant market area, are poor indicators of the state of competition.

By concentration we mean the number of banks as sellers of different services occupying the dominant position in a market. As Bain put it, "seller's concentration [is] described by the number and the size distribution of sellers in the market."[1] It refers to whether the seller in the market is one, few, or many, and to the number of sellers controlling a given percentage of the total market.

Economic theory suggests that existence of just a few competing units leads to resource misallocation, higher prices to consumers and discriminatory practices. This leads to the belief that concentration of banking units in a community means monopoly. On the other hand, it is argued, particularly within the commercial

---

[1]Bain, <u>Loc.cit.</u>, p. 5.

banking industry itself, that competition is as keen today as it has been for many years.[1]

We have concluded earlier that a single bank has a considerable degree of monopoly power, in a theoretical sense, limited only by the ability of borrowers and depositors to shift their business to banks in contiguous areas. Now we will see how they exploit their monopoly power and charge excessive prices. We will see the difference in interest rates offered by large and small banks to savings deposits, the different rates charged to borrowing customers, and the different service charges levied on depositors' accounts.

Table 4 compares the rates of interest paid to time depositors by various sizes of commercial banks. In the years 1960 and 1961 the difference between the smallest and largest sizes was insignificant; in 1959 the difference was slightly more than one quarter of one percent; in 1962 the difference was less than three quarters of one percent. The data, therefore, do not lend much support to the view that monopoly power is exercised in one bank towns, but if small banks are in one bank towns and they pay less, this is evidence albeit weak.

The service charges levied in 1962 by banks (per $100 of

---

[1]Mr. R. Gidney, Comptroller of the Currency's Testimony, U. S. House of Representatives, Committee on Banking and Currency, Regulation of Bank Mergers, 86th Congress, 2nd Session, 1960, pp. 134-137.

TABLE 4

INTEREST PAID ON TIME AND SAVINGS DEPOSITS BY INSURED COMMERCIAL BANKS OF VARIOUS SIZES

		Banks with Total Deposits of								
		Less than 1 million	1-2	2-5	5-10	10-25	25-50	50-100	100-500	500 or More
Interest paid per $100 savings deposits	1959	2. 22	2. 20	2.18	2. 18	2. 20	2. 25	2. 28	2. 33	2. 54
	1960	2. 45	2. 43	2. 44	2. 42	2. 40	2. 28	2. 39	2. 39	2. 47
	1961	2. 46	2. 49	2. 49	2. 49	2. 49	2. 52	2. 51	2. 49	2. 60
	1962	2. 34	2. 39	2. 51	2. 64	2. 74	2. 84	2. 88	2. 90	3. 08

Source: F. D. I. C., Annual Report, 1959-1962, pp. 134, 151.

demand deposit) rise with increasing bank size from the smallest class up to and including $10 to $25 million category. They then decline with increases in size. These data also do not indicate the exercise of monopoly power by banks in single bank towns.[1]

As far as rates charged to borrowers are concerned, small banks receive higher interest than do their larger counterparts. Whereas the smallest banks in 1962 averaged 6.39 percent on loans, the largest averaged 5.16 percent.[2] This is mainly due to small banks making small loans to small borrowers where risk and administrative costs are high. The opposite is true of the largest banks, whose loans tend to be relatively large and granted to borrowers with the highest credit ratings.

The monopoly power is further reduced by non-financial bank competition and secondly by improved transportation and concentration of facilities. These factors have undoubtedly helped to reduce monopoly power.

A study of resource concentration in 46 major banking markets in the United States in the period from 1939 to 1959[3] showed a stronger tendency towards reduction in bank concentration than towards increased concentration. The results of this study

---

[1]See Table 5, p. 52.

[2]Federal Deposit Insurance Corporation, Annual Report, 1962, pp. 134 and 151.

[3]Carson and Cootner, loc. cit.

TABLE 5

SERVICES CHARGES ON DEMAND DEPOSITS BY INSURED COMMERCIAL BANKS OF VARIOUS SIZES

	Less than 1 million	1-2	2-5	5-10	10-25	25-50	50-100	100-500	500 or more
Services charges per $100 demand deposit	$ .32	.36	.46	.59	.69	.62	.50	.39	.28

Source: F. D. I. C. Annual Report, 1962, p. 134, 151.

run counter to the notions held by the Antitrust Department.

According to this study, increases in concentration occurred in 14 areas, while decreases were observed in 31. The market share of the two largest banks in the 46 areas studied increased substantially in 9 cases, declined markedly in 25 cases, and showed nominal change in the remaining 12.

The distribution of largest banks controlling various percentages of total metropolitan area bank assets is summarized below.

1. In three areas the largest bank controlled more than 70 percent of the area assets in 1939. By 1959, none of these areas had this degree of concentration.

2. In 1939, the largest bank held more than 16 percent of total bank assets in seven metropolitan areas. In 1959, only one area had a bank of this size relative to the total bank assets.

3. In thirteen metropolitan areas the largest bank controlled more than 50 percent of the area bank assets in 1939. Twenty years later this was the case in only eight.

4. The number of areas in which the largest bank controlled less than 40 percent of total assets increased during the period from 21 to 64.

Summary

The present structure of commercial bank competition in the United States is the result of the interaction of economic forces and governmental regulation. Examination of the structure of commercial banking reveals two predominant industry patterns.

The first is found in rural regions where the market area is usually limited. In market areas which are narrowly circumscribed, potential monopoly power is generated from the demand side of the market.

The second type of market structure is found in large metropolitan centers with pronounced industrial concentration. Here the banking market structure conforms to the economist's concept of oligopoly or monopolistic competition.

The banks in monopolistic situations do not exploit their positions. Regulations and the character of the business prevent abuses of market power.

From the statistical data available, we can conclude that mergers do not necessarily increase concentration ratios. Even if concentration ratios were increased, it might make possible an extension of an individual bank's activities into markets not accessible to it prior to the merger and consequently increase competition. The banking industry does not have price competition and therefore it should not be treated as other business enterprises.

CHAPTER III

LEGAL IMPLICATIONS

Introduction

In the previous chapter competition is viewed as an important force encouraging the banking industry to operate efficiently. Competition is desirable not just for its own sake, but for the results it produces -- an efficient allocation of resources with production carried on at minimum cost and with minimum sustainable prices charged to consumers.

Unfortunately, encouraging competition in banking is not a simple matter. We cannot rely as completely on free market forces as we do in other industries because competition in banking is interrelated with problems of banking safety and other unique aspects of banking. If an enterpreneur sees an opportunity to profit by manufacturing steel, automobiles or cigarettes, he is free to do so. This is not the case in the banking industry. Establishment of new banking offices (unit bank, branch or consolidation) requires the approval of regulatory authorities who will take into account in making their decision the effect on competition and several "banking factors."

The justification for limiting entry into the banking business lies in need for a stable monetary system. Commercial banks are holders of a large fraction of community savings and means of payment. It is widely felt that banks must be shielded against the vigorous competition that characterizes some other industries in which failure is considered part of the game. In this view, the social costs of bank failures are considered to outweigh whatever inefficiency results from restricting bank entry. The role of banking system in the economy is of such enormous social, political, and economic significance that the extensive legal enforcement and restraint of market forces in the industry is deemed essential.

We have already mentioned that there are two institutions having administrative authority in regulating the banking industry: the office of the Comptroller of the Currency and the Banking Commissions of the various states. Their words are not final in cases of merger and the preservation or regulation of competition. They are respectively instruments of the U. S. Congress and the state legislatures.

In matters of merger and competition, banks, in common with all other business enterprises and notwithstanding their unique structure and function, are subject to the Sherman Act (1890) and the Clayton Act (1913), as amended by the Celler-Kefauver Bill (1950). These Acts are administered by the Antitrust Division of the Department of Justice. In addition to the general antitrust legislation, proposed mergers must satisfy the requirements of the Bank Merger Act (1960).

Acts of Congress of necessity are written in broad terms indicating the intent of the legislative body of the Government subject to the veto power of the President and the right of the judicial review of the Supreme Court. In other words, an Act of Congress furnishes a Statutory Standard for the guidance of the courts. Through experience with actual cases brought before the courts a body of case law is developed to produce a more specific criterion for acceptable action, the Case Standard. With acts such as the Bank Merger Act we may interpose a third criterion, the Administrative Standard where a regulatory agency is charged with the responsibility of administering an Act of Congress. The Administrative Standard is subject to challenge and modification by the courts but nevertheless shapes the body of case law developed by virtue of the expertise acquired in the problem area by the officials of the regulatory agency.

Sherman Act

Sections 1 and 2 which may be applied to bank cases read as follows.

> Sec. 1. Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with Foreign nations, is hereby declared to be illegal . . .

> Sec. 2. Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons to monopolize any part of the trade and commerce among the several States, or with Foreign nations, shall be deemed guilty of a misdemeanor . . .

A recent and a very important case which was brought up by the Department of Justice to the Supreme Court to block the merger was that of the First National Bank and Trust Company of Lexington with Security Trust Company of Lexington, Kentucky. The charges constitute a combination in restraint of trade and commerce in violation of Section 1 of the Sherman Act and a combination and an attempt to monopolize trade and commerce in violation of Section 2 of that Act. On April 16, 1964, the Supreme Court enjoined the proposed merger ruling that the merger would be in restraint of trade.

The facts relevant to the alleged restraint of trade under the Sherman Act on which the court relied were:

1. The size relative to their competitors of the First National and Security Trust before the consolidation and of the First National and Security Trust after consolidation;

2. The competitive position before the consolidation of the First National and Security Trust in the more limited area of trust business; and

3. "testimony in the record from three of the four remaining banks that the consolidation will seriously affect their ability to compete effectively over the years . . ."[1]

---

[1]U. S. vs. First National Bank and Trust Co. of Lexington and Security Trust Co. of Lexington, Kentucky. 208 F. Suppl. 457, 460. p. 4.

The testimony to which the court adverts was provided by competitors of First Security and Trust and was characterized by the district judge who heard it as seemingly "based merely upon surmise and. . . lacking in factual support."[1]

Both banks are located in Fayette County with competition of four other banks. In the district court's decision, "before and since the consolidation. . . all the banks in Fayette County have been operated successfully in the field of commercial banking and in competition with each other."[2] Many witnesses, most of whom were men of long experience in the field of banking, testified that this consolidation would not lessen competition in the area and did not tend to create monopoly in that field.

> According to their testimony, the fact that the merged bank had a large percentage of the trust business of the community did not and would not substantially restrain or lessen competition in the field of commercial banking.[3]

The case was not covered by Sections 1 and 2 of the Sherman Act as the motive behind this consolidation is no conspiracy in "restraint of trade," but a program of expansion and the possibility of enjoying the benefits of economies of scale. This bigness could be beneficial as the competitors would improve their resources when the institutions merged. They could pass their lower unit

---

[1]*Ibid.*, p. 6.

[2]*Ibid.*, p. 17.

[3]*Ibid.*, 208 F. Supp., 459-460.

cost of production on to consumers in the form of lower prices and better services. The opinion of the district court was that "the consolidation herein referred to clearly appears to have been the result of a lawful program of expansion on the part of the merging banks rather than an invidious scheme to restrain competition or to secure monopoly in the local field of banking."[1] The Supreme Court rejected the findings of the district court and concluded that the consolidation violated the Sherman Act on the ground of "bigness."

The major problem of applying Section 1 of the Sherman Act is the definition of "restraint of trade." Unfortunately, no straightforward definition can be given, for "restraint of trade" is a legal term of art. Taken literally the phrase seems to cover any restriction on the freedom of traders to make whatever bargain they please. However, many laws restrict freedom of bargaining, yet would not normally be regarded as being restraint of trade. A. D. Neale defines "restraint of trade" as: "Business behavior which in pursuit of profit prevents some form of competition from operating in the market."[2]

The banking industry, as we know, is highly regulated. Price competition in "pursuit of profit" would not be advantageous. There

---

[1]Ibid., 208 F. Supp., 460.

[2]A. D. Neale, The Antitrust Laws of the United States of America: A study of Competition Enforced by Law (Cambridge University Press, 1960), p. 12.

is a limit on interest rates paid on time deposits and prohibition of interest payments on demand deposits. As banking is not like other industries, it would be in a precarious position if it lowered the prices on its products. Mr. Saxon in his statement of decision apropos the proposed merger of the National Bank of Westchester, White Plain, New York and the First National City Bank of New York said: "It is not within the power of banks, as is true of industrial corporations, to increase freely their productive capacity. A bank which attempted to use lower interest rates on loans as a means of driving out competition would very soon find itself without loanable funds."[1]

Clayton Act

Section 7 of the Clayton Act applied to bank mergers by the Department of Justice reads as follows:

> No corporation engaged in commerce shall require, directly or indirectly, the whole or any part of the stock or other share capital . . . of another corporation engaged also in commerce wherein any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition or tend to create a monopoly.[2]

The most famous case blocked by Antitrust under the Act was the proposed merger of the Philadelphia National Bank and Girard

---

[1] 100th Annual Report of the Comptroller of the Currency for the year ending December 31, 1962 (Washington, D. C.: U. S. Government Printing Office).

[2] Act of December 29, 1950, Public Law 899, Sec. 7, 38 Stat. 731, as amended: 15 U. S. C. 18.

Trust Corn Exchange Bank, Philadelphia, approved by the Comptroller of the Currency. The grounds of this hold were that if the merger were allowed it would be detrimental to competition. The prime legal issue in this case[1] was whether Section 7 of the Clayton Act, as amended in 1950 by the Celler-Kefauver Act,[2] applied to bank fusion of the form typical in the banking industry. The case was approved in the District Court which found no competitive injury in the commercial banking line of commerce.

On June 17, 1963, the Supreme Court enjoined the proposed merger, ruling that the merger would be in violation of Section 7 of the Clayton Act. The importance of the decision stems from the fact that the narrow competition criterion contained in Section 7 of the Clayton Act would be controlling for bank mergers rather than the broader criteria of the Bank Merger Act.

In this case and in one earlier case, the court considered in a direct fashion only commercial banking in its entirety as a relevant line of commerce.[3] In this way the court precluded the evaluation of the competition offered by the "fringe" suppliers, financial institutions other than commercial banks, whose products

---

[1]U. S. vs. The Philadelphia National Bank et. al. 374 U. S. 321 (1963).

[2]Act of December 29, 1950, loc. cit.

[3]U. S. vs. Philadelphia National Bank, et. al., loc. cit. and Transamerica Corporation vs. Board of Governors of Federal Reserve System, Federal Reserve Bulletin, August, 1953, p. 840.

are close substitutes and thus enjoy competitive positions in the same market. The market can be broadened by considering the substitutes and shortened to exclude these fringe dealers.

The test of the lawfulness of a merger under the Clayton Act is whether the effect of the merger "may be substantially to lessen competition in any line of commerce in any section of the country." There are two major problems in applying this test: (1) what is the relevant "line of commerce" and (2) what is the relevant "section of the country."

Before going into the details of the Supreme Court decision we should like to point out that the district court ruled earlier in the same case that the merger would have no competitive injury in the commercial banking line of commerce. Their failure to find injury raises the question as to why an examination of potential injury to other lines of commerce was not pursued. Section 7 had been interpreted in earlier cases as prohibiting mergers where injury was found in any line of commerce. Judge Clary stated, of course, that he could see no useful purpose in "going any further than designating commercial banking a separate and distinct line of commerce." In light of his failure to test other lines, he apparently meant that he found none of the other lines suggested by plaintiff or defendant to be relevant. If he found none of the individual credit and deposit lines to be relevant, he evidently perceived the commercial banking line of commerce as composed of unique multiple product firms only, and not as a representative for the unique products and services commercial banks are frequently alleged to produce.

The Supreme Court in this case professed to have no difficulty in determining the relevant "line of commerce":

> We have no difficulty in determining the 'line of commerce' [relevant to product or services markets]. . . in which it appraise the probable competitive effects of appellee's proposed merger. We agree with the district court that the cluster of products [various kinds of credit] and services [such as checking accounts and trust administration] denoted by the term 'commercial banking' . . . composes a distinct line of commerce.[1]

It is quite clear that commercial banks do deal in a wide range of services and products, and also face a substantial amount of competition from non-bank financial institutions. Commercial banks are not products, nor are "total deposits," "total assets" or even "total loans." It is a more reasonable approach to the competitive problem to examine each of the relevant product lines and determine whether the merger will result in a substantial lessening of competition in the market for that product.

In examining the market for real estate loans, for example, it would be desirable to consider not only the amount of business done by the merging banks and the other commercial banks but also the mortgage loans of other non-bank financial institutions -- mutual savings banks, savings and loan associations, and insurance companies. The same is true in the personal loans, where competition

---

[1] Ibid., p. 356.

is from finance companies and credit unions.

The one product line in which commercial banks face no direct competition from other financial institutions is in the handling of demand deposits. Even here, however, they have some substitutes. Currency, of course, is one alternative, traveler's checks and register checks sold by many savings banks and savings and loan associations are others.[1]

The court's justification for disregarding non-bank competition is that commercial banking products and services enjoy "such a cost advantage as to be insulated within a broad range from substitutes furnished by other institutions."[2] Nevertheless, there is competition between commercial banks and small companies, and, perhaps more important, competition between commercial banks and both credit unions and sales finance companies which charge rates comparable to those of the commercial bank.

The court also found "no difficulty in determing the . . . 'section of the country' [relevant to geographical market] in which to appraise the probable competitive effects" of the merger. The court argued that convenience of location is important in banking competition:

> Individuals and corporations typically confer the bulk of their patronage on banks in their local community; they

---

[1]D. Carson and P. M. Horvitz, "Concentration Ratios and Competition," The National Banking Review, September, 1963, p. 109.

[2]U.S. vs. Philadelphia National Bank, loc. cit., p. 356.

> find it impractical to conduct their banking business at a distance. . . . The factor of inconvenience localizes banking competition as effectively as high transportation costs in other industries.[1]

Under Pennsylvania law, banks may establish branches only in counties contiguous to the county in which the banks have offices located. The Philadelphia National Bank and Girard Trust Corn Exchange Bank, each with home offices in Philadelphia County, may establish branches only in the adjacent counties of Bucks, Montgomery and Delaware. The court, therefore, decided that these four county areas in which each bank's office is located would be the relevant geographical areas.

It follows from the analysis of market structure of the preceding chapter that a single geographical area cannot be chosen as the relevant market area in which to measure competition. The relevant market area differs for each banking product or service. The relevant market area for personal checking accounts is probably a small one and the four county areas may be reasonably good choice. The relevant market for large deposits and business loans, however, is a national one. Philadelphia banks compete in this market with banks in San Francisco and Chicago as well as those in Pittsburgh and New York. Only 54 percent and 63 percent of the business loans of Philadelphia National and Girard are to firms located in the four county areas.[2]

---

[1] _Ibid._, p. 358.

[2] Carson and Horvitz, _loc. cit._

The Supreme Court explicitly rejected the arguments maintained by the Philadelphia National Bank and Girard Trust Corn Exchange Bank under Section 7. The first argument presented by them was that the merger will increase the lending limits, which will enable them to meet the credit needs of some of the larger corporations. The argument can be considered on its merits under the Bank Merger Act.

The strong argument rejected by the Supreme Court is that the merged concern will enjoy the larger scale of operations, which would allow lower unit costs of product or services. These lower costs would in turn be passed on to consumers in the form of lower prices. This is evident from the analysis of our preceding chapter. In Table 4 and Table 5 we observe that with the increase in the size of banks the interest paid on savings deposits increased. Service charges on demand deposits increased bank size from the smallest class up to and including the $10 to $25 million category and then declined rapidly with subsequent increase in size. Regarding the interest charged to borrowers, small banks received higher interest than did their larger counterparts.

Lyle E. Gramley, in a study prepared for the Federal Reserve Bank of Kansas City, found "differences in efficiency" favorable to large banks over small banks which he attributed to "the opportunities that are made possible by larger-scale operations to adopt modes of organization that make better use of labor resources."[1]

The advantages of large scale operation in banking were their dealing in "product mix," which reduced the risk by diversifying their resources.

Bank Merger Act

The merger of national banks, approved by the Comptroller of the Currency, was decided under the Bank Merger Act which applied the following test:

> In granting or withholding consent . . . the Comptroller, the Board, or the Corporation, as the case may be, shall consider the financial history and condition of each of the banks involved, the adequacy of its capital structure, its future earnings,prospects, the general character of its management, the convenience and needs of the community to be served, and whether or not its corporate powers are consistent with the purposes of this Act. . . . The appropriate agency shall also take into consideration the effect of the transaction on competition (including any tendency toward monopoly), and shall not approve the transaction unless, after considering all such factors, it finds the transaction to be in the public interest.[2]

Seven factors are enumerated in the Bank Merger Act. The first six are concerned with the quality of assets, adequacy of assets, adequacy of capital, competence of management, earnings prospects, and "the convenience and needs of the community to be served." The seventh factor named in the Act is a sign of the

---

[1]Gramley, loc. cit., p. 59.

[2]Act of May 13, 1960, Public Law 86-463, 74 Stat. 129, 12 U. S. C. 1828 (c).

times. It deals with the effect that the merger will have "on competition (including any tendency towards monopoly)."

There are three major differences existing between the merger criteria of the two Antitrust Laws and Bank Merger Laws:

1. The competitive criteria of the Bank Merger Act are significantly broader than those of Section 7, Clayton Act.

2. The Merger Act contains a number of points which must be considered along with the competitive criteria by the bank supervisory agencies in evaluating a merger, while the narrow competitive criterion of Section 7 is the sole standard of the Clayton Act.

3. The Bank Merger Act calls upon the bank supervisory agency to weigh all the relevant factors noted in the light of the "public interest" while there is no explicit "public interest" standard in Section 7 of the Clayton Act.

We have seen from the above legal provisions of the Merger Act cases that competition is one of several factors to be considered in approving a merger. The above provision indicates that competition is just one of several factors to be considered when a ruling is made on the merger of two or more banks. Situations may exist where a merger actually lessens competition. However, other points benefiting the banking public may be more significant than the effect on competition. Similarly, the granting of new charters or de novo branch openings in an area which would have the effect of increasing competition may be withheld due to other factors not in the public interest.

As noted above, even under competitive criteria the broader wording of the Bank Merger Act would allow some factors, such as differential impact on competition in several markets and at the post merger level of competition, to be given different importance than has been done in Section 7, Clayton Act. There are other factors which should have been taken into consideration in arriving at a decision of bank merger included in the Bank Merger Act. The court rejected the economies of scale argument as irrelevant for Section 7, Clayton Act. The argument could be considered under the Bank Merger Act.

The need for a solvent banking system does not imply that the individual banks must be insulated from the vigorous competition of rivals, old or new. The other factors should also be considered, where the banking industry could operate more efficiently.

Mr. Saxon commented on another proposed merger of the National Bank of Westchester, White Plains, New York and the First National City Bank of New York in 1962, which he disapproved for reasons other than its injury to competition. He said:

> This is a view charged with emotionalism and characterized at the present time by an almost complete lack of clarity and objectivity, brought about in part by an indiscriminate use of conceptual terms. There has to our knowledge been no adequate study of bank competition or the standards by which the effects upon competition of bank mergers should be measured. The nature of commercial banking and the regulatory framework under which it operates distinguish banking from the type of industrial enterprise to which the general antitrust laws were designed to apply, and render

highly questionable for judging bank mergers the concepts developed in the application of these laws of industrial corporations.[1]

Every merger case has a different situation and should be judged by the circumstances under which it is proposed rather than being blocked only by the competitive account as has been done recently.

It is not within the scope of this study to analyze all the cases brought to the forefront by the Antitrust Department under Section 7 of the Clayton Act and Sections 1 and 2 of the Sherman Act and the merger proposals applied by the Comptroller of the Currency. We have, however, observed that the Antitrust Department's main aim is to prevent a lessening of competition and the approving authority's object is to see that the "conveniences and needs of the community" under the Bank Merger Act are met. None of the parties considered the optimum size of a bank or the conditions for economic efficiency. Competition is not the appropriate concept to take as the basis for the analysis of the conditions of economic efficiency. The fundamental concepts are the flow of resources to uses where utility is maximized and the mobility of factors of production. Two principal aspects of mobility are (a) switching resources in response to changes in demand and to meet the new demands created by new techniques, and (b) bringing

---

[1]"Comptroller's Decision in the Westchester Merger," Banking, February, 1962, p. 110.

lower cost factors of production into use in place of higher cost factors. Promoting and encouraging factor mobility is a central economic problem that all societies have to face.

Competition is, of course, one means -- and an important one -- towards the end of mobility. But it is untrue that there cannot be mobility without competition -- witness the economic growth of countries in which competition is given no great part to play. There can be some examples in which competition positively impedes mobility, such as the industry in which large scale research and development are needed for new and improved products. In the banking industry much research has to be carried on in order to predict the market condition and thus act accordingly. In order to be more efficient and up to date, banks have to use modern techniques.

Where an industry already has an oligopolistic structure such as that of the banking industry, the arguments for the lessening of competition by merger and acquisition are not relevant. The surviving firms of an oligopoly are strong and large enough to enjoy scale economies and thus be economically efficient. The Clayton Act applied to the banking industry in cases of mergers, consolidation or acquisition of assets, where such agreement lessens competition (including the tendency towards monopoly), contains a large admixture of "small banks" sentiment. The arguments in the Clayton Act cases are not economic; the question of whether there is effective competition among the existing banks and whether the economic efficiency of merged banks is overridden by the question of whether their practices diminish the opportunities of small banks to join in the game. The same is true for the cases enjoined under the Sherman Act only on the fear of "bigness," and no economic argument has been given so far.

We have seen in our earlier discussion that small banks have their own local market and have their share of this market. The monopoly power these small banks enjoy could not be reduced only by prohibiting a merger, but by reducing the barriers to entry.

Table 6 indicates the mergers, consolidations and purchases of assets approved by the Comptroller of the Currency, Mr. James J. Saxon, from November 16, 1961 through April 19, 1963. The acquiring and acquired banks are grouped here according to the amounts of their deposit. These are further classified as small, banks under \$5,000,000; medium size, from \$5,000,000 to \$50,000,000; and large banks, who have deposits over \$50,000,000. Our study shows that the largest number of banks acquired are medium size banks and are consolidated into the large size banks. The second largest acquisition is the small and medium size banks, and the third largest among medium size banks.

This study revelas that the disagreement of some economists and bankers who argued that the recent mergers were big banks consuming small banks and thus lessening competition, or merging amongst themselves and increasing concentration ratios, is inaccurate. The arguments are merely based on surmise and

TABLE 6

MERGERS, CONSOLIDATIONS, AND PURCHASES OF ASSETS APPROVED BY THE COMPTROLLER OF THE CURRENCY FROM NOVEMBER 16, 1961 THROUGH APRIL 19, 1963

Banks Grouped According to Amount of Deposits	Less than 1*	1-2	2-5	5-10	10-25	25-50	50-100	100-500	500 or More	Total Acquired Banks
Small										
Less than 1				2	1					3
1-2			3	1	5	1	2			12
2-5	1			4	11	7	6	7	2	38
Medium										
5-10				2	7	8	9	14	1	41
10-25				1	4	2	4	12	4	27
25-50					2		3	7	1	13
Large										
50-100								1	2	3
100-500	1							1		2
500 or more										
Total										
Acquiring banks	2		3	10	30	18	24	42	10	139

*Numbers given in millions

Source: U. S., Congress, House, Committee on Banking and Currency, Conflict of Federal and State Banking Law, 88th Cong., 1st Sess., 1963.

lack factual support. We see that the main banks acquired are medium size banks, who in order to meet the needs of growing communities have to grow with them. Secondly, the medium size banks want to grow in order to enjoy the benefits of large scale operation, which will allow lower unit cost of product and service. Thirdly, most of the small banks merged with medium size banks in order to operate more efficiently by approaching more closely to the optimum size for the conditions of the market area.

Mr. James J. Saxon, Comptroller of the Currency, appointed November, 1961, was aware of the criticism and emphasis being given to the merger. He stated in an address before the Banker's Association, Miami Beach, Florida, on March 22, 1963:

> Great concern has been expressed that any move to enlarge banking facilities -- whether through new charters, new branches, mergers or holding companies -- would quickly deteriorate into a plethora of banks, which could lead only to destructive competition fatal to the solvency and liquidity of many institutions. Some feel that the inevitable outcome would be virtual disappearance of small banks, thus bringing about an excessive concentration of banking control. None of these doubts are, in my judgment, well supported. [1]

Summary

The Antitrust Laws, Section 7 of the Clayton Act and

---

[1] James J. Saxon, "Non-Branch Banking Policy -- A Formula for Stagnation," The Commercial and Financial Chronicle, April 25, 1963, p. 13.

Sections 1 and 2 of the Sherman Act, applied to the commercial banking industry, are inequitable. Our study of the banking market reveals that the banking industry should not be treated as other commerce. It is altogether a "different animal" and should be treated as such. Many of the existing regulatory practices and some banking legislation are frankly intended to restrain competition in commercial banking. The stockholders benefit from the restraint of competition achieved through entry and branching restriction, ceilings on deposit interest, and similar measures. The use of government regulation to protect the stockholders is itself contrary to competitive philosophy. The growth through merger of banks is not the only thing to be precluded in order to maintain competition. There should be some other gradual modification of current regulatory practices:

1. The question of permitting banks to resume the payment of interest on demand deposit may be re-examined.

2. In the climate that such developments could well establish there is a possibility that the state policies toward branch banking may become somewhat more liberal, especially in states where tight unit banking may tend to preserve local banking monopolies.

3. Another likely possibility is for public policy, both Federal and State, to encourage competition in banking by sharply reducing restrictions on new bank charters and new branch offices with a view to allowing the relatively free play of business com-

petition to determine entry into banking as it does in manufacturing and other industries.

4. The question of lifting of interest rate ceilings on savings deposits may be re-examined. The ceiling on savings deposits placed commercial banks at competitive disadvantage with their non-bank financial competitors.

The view expressed above are carried on by Saxon in his philosophy of expansion in banking industry, through his liberal policy of branches, new entry and mergers. The following chapter is devoted to his expansion planes through branches and new entry.

CHAPTER IV

BRANCH BANKING AND THE MERGER MOVEMENT IN UNITED STATES BANKING

Introduction

The attitude of the Comptroller of the Currency, Mr. James J. Saxon, towards bank mergers is strongly conditioned by the demonstrated effectiveness of branch banking in meeting the present day banking requirements of the American people. Branch banking, as we shall show in this chapter, when viewed in relation to criteria of public benefits possesses significant advantages over unit banking without necessarily impairing the overall competitiveness of the banking industry. In fact, branch banking may lead to increasing rather than stultifying competition within the industry.

Where Federal and State regulations and regulators permit, merger is a convenient device for effecting a change in the structure of the banking industry away from unit banking and towards branch banking. The proliferation of branch banking does not, of course, arise from merger alone but also by the occupancy of additional premises by banking firms operating elsewhere in the metropolitan area, county or state experiencing an increase in branch banking.

As in all questions affecting the American banking industry, we can make relatively few policy statements which are universally true in all 50 states for State and for Federally chartered banks. Consequently the main trend of the discussion in this chapter is devoted to Federally chartered rather than State chartered banks.

Historical Trends

The trend in the United States banking structure towards increased use of the branch form of organization continued from the first decade of the twentieth century. The first two decades witnessed a tremendous growth in the number of banking offices and banks. These were years of rapid industrial and agricultural advance, accompanied by the development of the American West and by rising land and commodity prices. The peak was reached in 1920 and then the number of banks began to fall. The number of banks continued to decline, though slowly, from 1933 to 1945 due to mergers. The number of branches rose almost uninterruptedly throughout the whole period. This trend has continued up to the present time.

The change in the banking structure in favor of the branch form was aided by banking legislation passed in 1933. The MacFadden Act and the Banking Act liberalized the power of national banks to establish branches. Several states passed legislation liberalizing their branch banking laws so that 34 states now permit some form of branch banking.[1] Nevertheless, the United States still has a dual banking system of State and Federally chartered banks, each allowing both unit and branch banking.

The effect of the branch banking movement on the structure of banking markets has been a subject of controversy for many years -- from the earliest debate concerning the First and Second Bank of the United States,[2] through concern over the branches of "wildcat" banks that accepted deposits but did not honor withdrawals. Fundamental changes in branch banking laws were instituted in the 1920's and 1930's, continuing to the present day. The conflicts which existed in 1900 between different types of banks and regulatory authorities have not been resolved and, in fact, have become more intense.

Mr. Saxon and Branch Banking

Mr. Saxon, and a good many other people, believe that present restrictions on branches often work not for competition but against it. A study of this viewpoint has been prepared by Bernard Shull and Paul M. Horvitz, senior economists, in the office of the Comptroller of the Currency.[3]

[1] See Table 7.

[2] J. M. Chapman and R. B. Westerfield, Branch Banking (New York and London: Harper & Brothers, 1942), p. 22.

[3] B. Shull and P. M. Horvitz, "Branch Banking and Competition," The National Banking Review, March, 1964.

Competition in banking, as in any other industry, is affected by a number of factors. High on the list are such things as number of competitors, the degree of concentration, and the ease with which new competitors can enter the field. For the effects of branch banking on competition we must see:

A. whether branch banking results in a small number of competing institutions;

B. whether branch banking results in significantly higher concentration; and

C. whether branch banking discourages the entry of new banks.

A. The total number of banks has declined by about 700 between the years 1953-1962. Opponents of widespread bank branching make much of the fact that many independent banks during that period were absorbed by other institutions and converted into branch banks. However, this fact has had little relevance to the spread of bank branches. In 1963, for example, only 139 new branches resulted from such mergers while 1065 new branches were started from scratch.

In communities outside metropolitan areas, there is little difference between branch and non-branch States in the number of banks available to an individual customer. In metropolitan areas of less than 500,000 population, the difference is also small. Larger cities in non-branch States tend to have many more banks than comparable cities in States that permit branching.

However, this does not necessarily mean that competition suffers in the branch bank States. Many individuals and corporations will have access to banks throughout a large city and in other cities as well, but many more are likely to do business only in banks in their own neighborhoods. Thus a large metropolitan area in this sense may not be one market but many. When branch restrictions bar a bank from moving into other parts of its metropolitan area, the effect may well be anti-competitive and against the public interest.

B. We turn now to concentration ratios. In the proportion of a community's bank deposits held by the largest banks, Messrs. Shull and Horvitz find no significant difference between branch and non-branch States. On the average, the two largest banks in metropolitan areas of non-branch States held 60 percent of their area's deposits in 1962, compared with 67 percent for branch States. It would be difficult to argue that this disparity was of real economic significance.

C. Whatever the present pattern of concentration, this pattern can be altered by the entry of new banking offices. Actually, the branch banking States have acquired more new banks than those States that permit no new branches in relation to the banks in existence in 1953.

Furthermore, when new branches (those started from scratch) are counted, the branch States have added new banking offices at a much faster rate than the non-branch States. One reason for this is simply the regulators' reluctance to charter new banks that may fail or cause others in the community to go out of business. In non-branch States the new bank, as are all its prospective competitors, is a self contained institution. It must stand or fall on results in its own area. In branch States, the new banking office, as are some of its competitors, may be a branch of a large institution. Failure of a branch office need not endanger the whole institution.

There are other factors which seem to argue in favor of branches. The nature of most metropolitan areas is changing; there is no sensible reason why banks in the centers of cities should be barred from following their customers to the suburbs. Such rigid curbs as currently exist deny the flexibility that any industry needs in a modern economy. For such reasons Mr. Saxon has been urging that the national banks be given limited branching power in non-branch States.

<u>Opposition to the Growth of Branch Banking</u>

Many State regulators and State-chartered banks claim that Mr. Saxon's policy threatens to create havoc in the nation's banking system. Three basic fears have been expressed:

1. that there is particular danger of undue bank concentration where the branching technique is employed;

2. branching threatens the position of unit banks; and

3. that branches will lead to overbanking.

Mr. Saxon dealt with these fears one by one in an address before the Annual Spring Dinner of the New York Financial Writers Association on May 27, 1963. He remarked that the branching restriction is not the proper means of controlling bank concentration: "Improperly conceived branching limitation may actually increase, rather than diminish, the probable degree of such concentration."[1] His liberal policy of expansion and less restricted entry has favorably reduced the degree of concentration in the banking industry: "The fewer the sources of competition which may enter any market, the greater is there likely to be the degree of concentration."[2] This issue is often confused by the degree of concentration found in the 100 or 200 largest banks. This test does not , however, truly reveal the concentration which prevails. Each bank deals in a different market or markets and is not competitive with all the banks in the nation. If there were only 200 banks in the United States, and each competed in every market area in the nation, there would be far more competition than now exists.

The second fear expressed by State authorities is that Mr. Saxon's philosophy of expansion is a threat to the dual banking

---

[1]James J. Saxon, "What Kind of Banking Structure Do We Need: Role of Branch Banking," Address before New York Financial Writers Association, May 27, 1963.

[2]*Ibid.*

system of the United States, since it puts unit banks in a disadvantageous position. Mr. Saxon, commenting on this fear, said:

> [The State banking authorities] view the control of bank entry and bank expansion as a matter which should be handled through what amounts to the allocation of financial markets. They would approach this problem by parceling out these markets among National and State-chartered banks, so that each group, and individual banks within the group, would have assured territories reserved to them. . . . It is a bleak picture we would have to paint for the future of our banking system, if our efforts were to be centered safeguarding the markets for any segment of that system. The progress of our entire economy would be severely hampered if we regarded this to be the purpose of public control in the field of Banking.[1]

Branch banking is being liberalized because of the services the community derives from larger scale banking operations. The cost advantages obtained from larger scale operations could be realized in any industry in which there are substantial fixed investments or specialized personnel capable of more extensive use, and not only through branch banking. The object of public policy should be, not to safeguard banks of any size, but to assure that the public's needs are met to the best advantage by whatever institution can do the job most effectively. The proper standard applied is the one of public benefit. The application of this standard does not mean "that there will be no proper place in the

---

[1]U. S., Congress, House, Subcommittee on Banking and Currency, Conflict of Federal and State Banking Law, 88th Cong., 1st Sess., 1963, p. 278.

banking structure for unit banks, and banks with few branches. The capability of banks to survive competition is not solely dependent upon the scale of their operations. For many banking services, size confers no advantage. Moreover, our experience shows that well managed, adequately capitalized, aggressive smaller institutions can prosper and progress alongside the largest banking institutions we have in our country. For such banks, which rely upon their own efforts, and not upon public protection against competition, there will always be a place in banking structure."[1]

The fear of over-banking is to a large degree a survival of the unhappy experiences of the 1930's and of earlier periods of crisis, which produced many of the excessive banking regulations which prevail today. It is a valid purpose of bank regulation to safeguard the solvency and liquidity of banks -- but not without regard to the adequacy of banking facilities in the country. Under-banking is as much a public concern as over-banking. The proper test of bank expansion is to allow the forces of private initiative to be expressed in this industry in the degree and in the forms that are required to assure the public the services and facilities they must have to meet their needs. The safeguards should be public safeguards -- and not safeguards for individual banks. Mr. Saxon, however, is convinced that he is proposing not havoc but competition.

---

[1]James J. Saxon, "What Kind of Banking Structure Do We Need: Role of Branch Banking," loc. cit.

The conflict concerning branch banking exists not only between the Independent Bankers Association and branch bankers, but also between the IBA and some regulatory authorities,[1] the Comptroller of the Currency and between national and state banking authorities. The major part of the problem is related to the role of competition in banking.

Opponents of branch banking assert that because of concentration of banking units in the typical community, competition is lacking. This view has been best expressed by Congressman Emanuel Celler:

> The present degree of concentration is contrary, I think, to the fundamental premise that the banking system should rely for its vitality on vigorous competition by a multitude of independent banks, locally organized, locally financed, and locally managed. . . . As a result of the depletion in the ranks of the country's banks through mergers, competition among banks has been lessened in communities throughout the nation.[2]

Opponents of branch banking also argue that with branch banks entering a community smaller banks may be driven out of business, due to the operating economies and greater facilities offered by the former. The new branch cannot, even if it wanted to, use unfair tactics such as charging below cost interest rates on loans, as the rates are determined by the head office. Unit banks, therefore,

---

[1] Wall Street Journal, May 2, 1963, p. 1.

[2] U. S., Congress, House, Subcommittee on Banking and Currency, Regulation of Bank Mergers, 86th Cong., 2d Sess., pp. 134, 137.

are hurt by the entry of the branch office by loss of their monopoly position rather than cost advantages of the branch.[1]

On the other hand, it is argued, particularly within the commercial banking industry itself, that competition is as keen today as it has been for many years. This view is shared by former Comptroller of the Currency, Mr. Gidney, who testified as follows:

> Our banking system today is in a very healthy condition. With the strengthening of its management, capital position, and resources, there has been corresponding progress in the character of banking competition. Banks strive to furnish the most complete service possible and continually vie with each other in seeking enlargement of their customer groups, whether depositors, borrowers or users of other services.[2]

Structural Factors Influencing Bank Competition and Structural Change

A. Number of Banks

At the outset, we must not look at the large number of banks in the United States and conclude that banking is a very competitive industry. It is obvious that not all banks compete with one another. There are many more-or-less separate and distinct banking markets and it is important to stimulate competition in these separate banking markets.

---

[1]P. M. Horvitz, "Branch Banking, Mergers and Competition," Banking and Monetary Studies (Homewood, Ill.: (Richard Irwin, Inc., 1963), p. 315.

[2]U. S., Congress, House, Subcommittee on Banking and Currency, Hearings, on S. 1062, Regulation of Bank Mergers, loc. cit.

B. Growth of Branch Banking

The forces underlying the recent acceleration in the establishment of new banking offices fall into two groups. One includes factors relating to overall expansion of the economy which significantly affect the demand of banking services. The other group contains the main locational and structural shifts in American economic life: from agricultural and non-agricultural employment, from rural to urban residence, and from metropolitan to suburban residence. These latter factors are, of course, intimately related to growth, but their impact on bank expansion is in part distinct, since they imply not only a need for new banking offices but a possible shift in the relative importance of various services performed and hence in the types of offices needed.

C. Economic Growth Factors

Since a significant number of banking services are rendered directly to individuals, population growth per se is important to the demand for banking facilities. The United States has experienced rapid population growth, which even exceeded United States Census forecasts in the last few decades. Virtually all the pre-1940 forecasts of population growth for the period through 1955 were exceeded by 1950. The presumption of more rapid rates of increase in the 1960's and 1970's is reinforced by the coming-of-age during this period of those born during the post-war period.

The technological expansion is adequate provision of constant or rising per capita real income for this growing population, which will require very substantial expansion of capacity at all levels -- primarily production, processing and marketing. Hence the demand of business firms for commercial banking facilities may be expected to show rapid and sustained growth over the next several decades.

D. Structural and Locational Shifts of Industry and Population

The growth factors discussed above are operating at very uneven rates in different economic and geographic areas. Recent developments in this regard show two distinct lines of development. The number of persons employed in agriculture and residence on farms is declining, and it seems evident that during the next one or two decades this trend will continue. This shift of the contribution of agriculture to the national product and total employment is likely to produce some changes in the demand for banking services. The shift of resources out of agriculture enhances growth in real incomes and banking services are more familiar and convenient to urban residents.

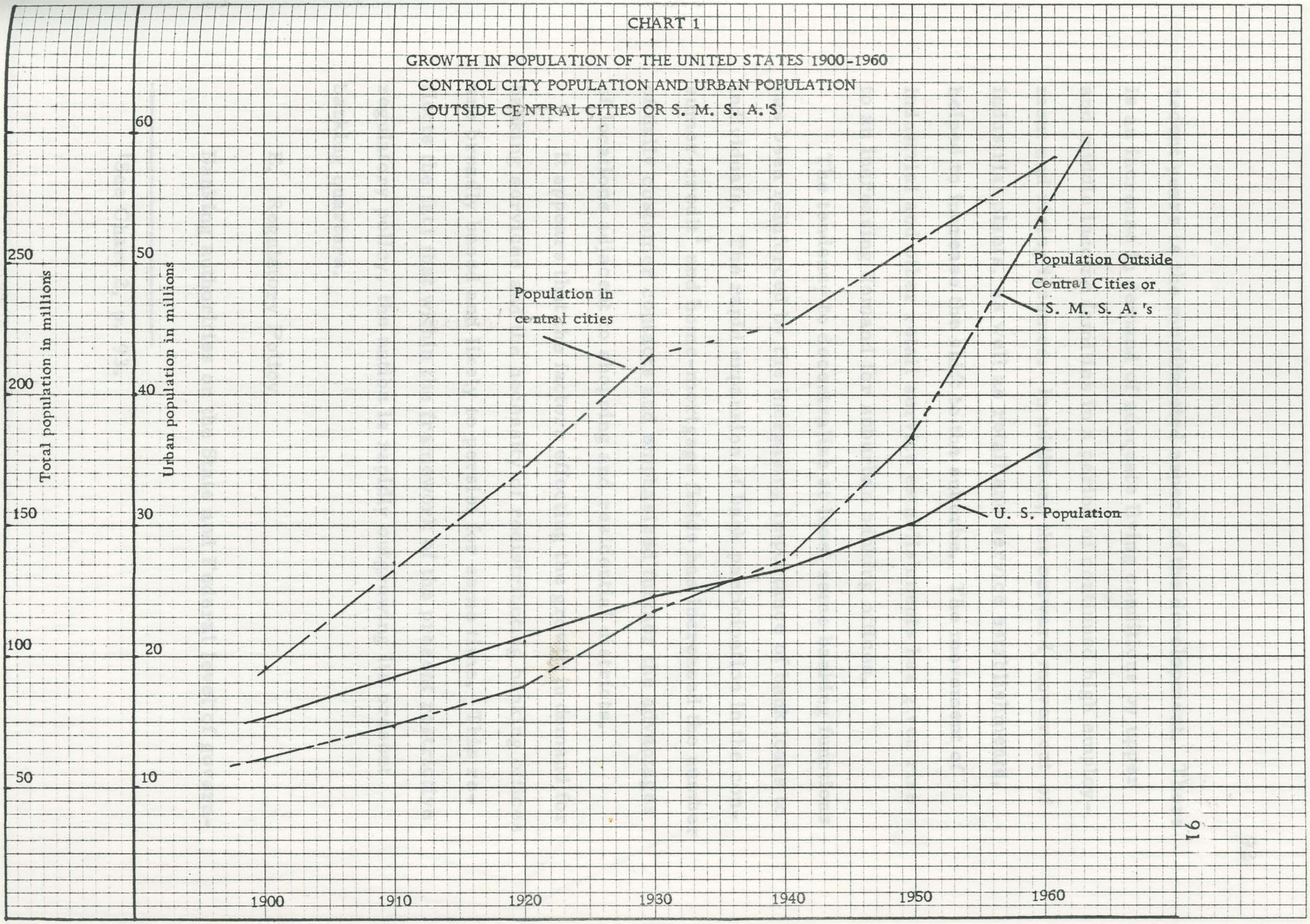
The second item of potential significance is the rapid population growth in the suburban communities of metropolitan areas. This shift has accelerated since 1954.[1] The most impressive feature of the decentralization of metropolitan population in

---

[1]See Chart 1, p. 91.

CHART 1

GROWTH IN POPULATION OF THE UNITED STATES 1900-1960
CONTROL CITY POPULATION AND URBAN POPULATION
OUTSIDE CENTRAL CITIES OR S. M. S. A.'S



recent years is the multifaceted aspect of the development. There is an increase in demand of adequate living conditions by upper and middle income families in a period of continued high employment and rising incomes. In addition, the outward movement of industrial plants, as well as retail and service establishments, helped to increase the shift to the suburbs. The movement of industrial and other retail service establishments has given rise to an increasing demand for suburban banking offices.

The tendency to decentralize at least some banking functions has been reinforced by the increasing importance of bank loans to individuals. The rapid expansion of bank participation in the consumer-credit[1] and home-mortgage fields has increased the number of daily customer contacts and emphasized further the advantages of locations adjacent to shopping and residential districts.

It appears that the factors effecting the growth in demand for banking services and the necessity of redistributing banking offices are broadly based and likely to persist for some time. This reflects the fact that within the framework of the present restrictive regulatory policy, the nation is rapidly outgrowing its present banking quarters.

E. Regulatory Policy

Banking authorities on the State and Federal level of govern-

---

[1]See Chart 2, p. 93.

CHART 2

GROSS NATIONAL PRODUCE 1930-1960

TOTAL AND COMMERCIAL BANKS' SHARE

OF CONSUMER INDEBTEDNESS

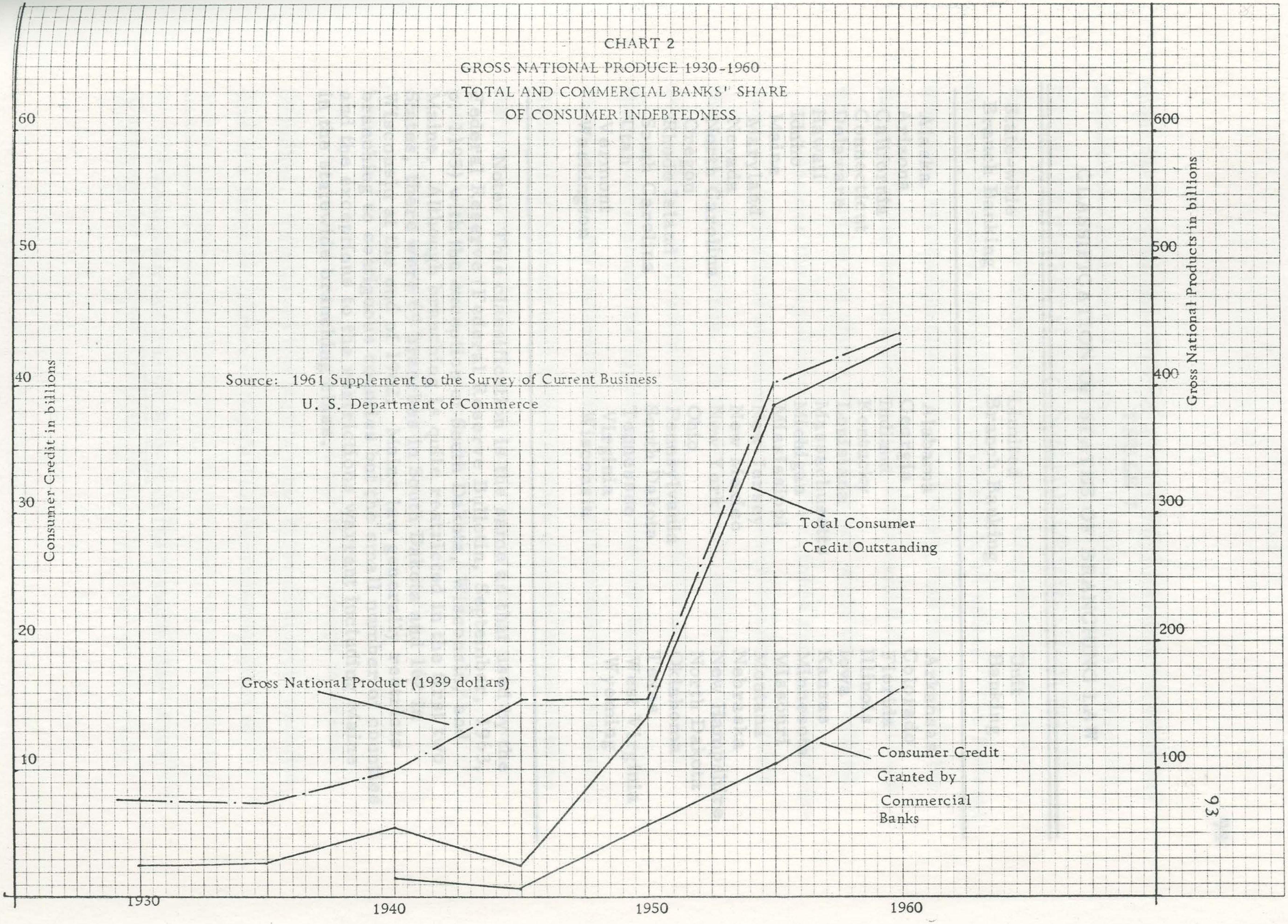


TABLE 7

CLASSIFICATION OF STATES OF BRANCHING LAW

State-wide Branch Banking	Limited Branch Banking	Unit Banking
Alaska	Alabama	Arkansas
Arizona	Georgia	Colorado
California	Indiana	Florida
Connecticut	Kentucky	Illinois
Delaware	Louisiana	Iowa
Hawaii	Massachusetts	Kansas
Idaho	Michigan	Minnesota
Maine	Mississippi	Missouri
Maryland	New Jersey	Montana
Nevada	New Mexico	Nebraska
North Carolina	New York	New Hampshire
Oregon	Ohio	North Dakota
Rhode Island	Pennsylvania	Oklahoma
South Carolina	South Dakota	Texas
Utah	Tennessee	West Virginia
Vermont	Virginia	Wyoming
Washington	Wisconsin	

Note: This classification is the same as that used by the Federal Reserve (Federal Reserve Bulletin, September, 1963, p. 1195) with the exception of South Dakota, Wisconsin, and Maine. Although branching is quite restricted in the first two States, there were 69 branches in South Dakota and 162 in Wisconsin at the end of 1962. Maine law generally restricts branching to contiguous counties but the small number of counties and the exceptions to the restrictions warrant including Maine in the statewide branching class.

ment have, as we have seen in the preceding section, strongly influenced the structure of competition in commercial banking through the exercise of their chartering powers. State banking authorities allow branches in 17 states, limited branches in another 17 states, and prohibit branches in 16 states. The Federal authority, the Comptroller of the Currency, has the power under the MacFadden Act and the Banking Act to establish national bank branches only in the states where state law would not be violated.

Besides the legislative restrictions, there are some administrative restrictions on branch banking which considerably limit the growth of branches. On the State level, authorities have often evaluated the application of a new branch on the same basis as they would evaluate the application of a new unit bank for a charter. On the Federal level, many applications for the establishment of national bank branches were annually disapproved on the grounds that the new branch would lead to destructive competition.[1] The administrative restrictions are somewhat liberalized under the expansionary program of the present Comptroller of the Currency, Mr. Saxon.

Many banks in branch restricted States merge to create branches. This eases the bank's most difficult current problem, that of a large migration of population from metropolitan to

---

[1] Ninety-second Annual Report of the Comptroller of the Currency for the year 1954, p. 13.

suburban areas. This shift in population leads metropolitan banks to follow their customers and to open offices for the convenience and need of customers at the place of their domicile. The shift has affected the bank's earnings in two ways: first through the drain on deposits which raises the capital-deposit ratio, and secondly through the shift of the loan business of the depositors to the local banks of their domicile.

<u>Advantages of the Branch Form of Structure</u>

Whenever there is need for additional banking facilities in the States where branches are allowed, this need is met with branching by existing banks. There are several reasons why these expansion needs have been made by branching rather than through chartering of new banks. We have discussed in the previous section the legislative reasons, but there are some economic factors influencing expansion through banking.

1. Branches can often operate profitably in communities which cannot support a unit bank. Many smaller communities or suburban areas present unbalanced banking business. Some wealthy suburban communities may manage to raise a sizable volume of time and demand deposits, but may have virtually no business loan demand. Other residential areas may provide substantial demand for installment and mortgage loan, but may not be able to generate adequate deposit volume. Branch banks provide mobility of funds and can shift excess reserves from one

place to the community with business loan demand.

2. The branch banks certainly are in a more advantageous position of employing experienced staff. The branch bank already has experienced staff which can be shifted to the new branch. The new branch needs to cover only the direct cost of its operation, at least at first. That is to say, it does not need to cover officers' salaries or even the expenses of maintaining an investment department or credit department, or some other highly specialized service department, as these already exist in the head office.

3. When there is any doubt about whether the community can support the banking office, it is more beneficial to open a branch office which can be closed without loss to depositors if it turns out to be unprofitable.

4. Savings in labor and other expenses that come with larger banking units emphasize the economies of large-scale operations. In discussion of costs of manufacturing, the point is often made that economies of scale are due to size of plant rather than size of firm. The multi-plant operation in banking is branch banking, which means lower cost with increase of the size of the bank.

5. If there are some initial losses which must be borne while the bank is establishing its place in the community, the branch bank can probably better afford these than a new small unit bank.

When a branch bank seeks to establish an office and the entry is restricted, it often attempts to gain a branch in the desired location through merger. This method is usually adopted in the States with limited branches. There are several other factors affecting this decision:

1. The existing banks already have customers and thus additional promotional expenses are minimized.

2. The existing bank already has an office; thus construction cost may be avoided.

3. The existing bank already has personnel, so that the employment problem is minimized.

Branching and Competition

We have observed in our previous chapters that economic theory supports competition. However, competition is not an end in itself. Competition is desirable because of what it leads to: an efficient allocation of resources with production carried on at minimum cost with minimum sustainable prices charged to consumers. Merely having a large number of competitors does not assure that these ends are being achieved. This is the gist of a large part of the problem of branch banking and banking competition. Opponents of branch banking focus on the number of banks and the concentration of banking ratio. Proponents of branch banking are more concerned with making the competitors really competitive.

Opponents of branch banking claim to be protecting competition. If a bank is permitted to establish branches in scattered communities around a State, they argue, it will tend to acquire monopoly power which will enable it to charge higher fees for its services. With this power, they further argue, a bank can move into a locality with a new branch and drive smaller banks out of business, thus reducing the number of competitors.

We have observed earlier that the banking industry, due to different State and Federal regulations, is not in a position to enjoy exclusive monopoly power. In the case of branch banking prices, the policy of maintaining the same interest rate and charges has been set by the head office. The head office of a large branch bank is likely to be located in large cities which have several other banks, and the rates are determined by competitive situations. Branch banking, in this manner, can be viewed as a means of transmitting the competition of the larger cities to small communities. For example, interest rates on automobile and personal loans were reduced by banks in New York's Westchester and Nasau Counties shortly after banks in neighboring New York City were authorized to establish branches outside the city.[1]

Summary

Due to different rates of development of economic and geographic areas in the United States in the last decade, the increased demand for banking services is not felt uniformly across the

[1]100th Annual Report of the Comptroller of the Currency, loc. cit., p. 140.

nation. Economic expansion requires the expansion of its main generator -- the banking industry. Expansion could take place either through the entry of new banks or the expansion of existing banks.

The shift of industrial location and structure encouraged the banks to follow their customers to the suburbs. These shifts do not only imply a need for new banking facilities, but a possible shift in the relative importance of various services performed and hence in the type of offices needed.

There are many regulatory, administrative and economic barriers to the new entry. In the markets where these barriers are substantial, the demand is met by expansion of existing institutions by creating new branches. The opponents of branch banking fear that this expansion leads to the higher concentration ratio and is thus less competitive.

Competition within the banking structure is not only due to the number of existing banks but also to the possibility of new firms entering the market. There are economic barriers to entry in every industry. These include such factors as product differentiation, economies of scale, and difficulties in obtaining certain factors of production such as management, capital, or labor. Though barriers to entry are not high in the banking industry, they are lower under branch banking than under unit banking.

Competition in branch banking structure is dependent on the number of banks in relevant banking markets, the degree of concentration in banking markets, and the ease of entry into banking. To analyze the effect of branch banking on bank numbers is to specify the banking market to be considered. Outside the metropolitan areas the difference between branch and non-branch States in the number of available banks is very little. In large cities the difference is significant. Our analysis of the banking market in previous chapters shows that the large markets are competitive and that it is only the local market which enjoys monopoly. The difference is very little in this local market and thus branch banking seems to have no adverse effect on competition.

Concentration in banking is high in most local markets. While concentration ratios are somewhat lower under unit banking, the differences do not appear to be very significant from an economic point of view. Messrs. Shull and Horvitz's analysis suggests that the structure of local banking markets has not been adversely affected by branch banking in the United States, either in terms of number of competitors or concentration, or in terms of condition of entry. The weight of evidence supports the opposite viewpoint; market structures are adversely affected by restrictions on branch banking.

CHAPTER V

SUMMARY AND EVALUATION

The controversy surrounding Mr. James Saxon's policies on bank merger can only be understood by referring to the historical circumstances which have shaped the views and fears of the protagonists.

From the latter half of the nineteenth century two basic fears have carried over into discussions on banking policy in the twentieth. On the one hand the periodic crises of liquidity and solvency have led to the creation of agencies at both the Federal and the State level to modify and restrain the forces of a competitive market; on the other hand geniune fears have been created by the specter of centralization of the financial decision-making process of the nation in the hands of a few men.

The trend towards bank mergers started in the 1920's and continued until the depression of the 1930's. The factors affecting the merger activity at that time were more of a life saving nature than due to other economic factors. The trend continued until 1940. With the increasing demand for banking services, the need was met more by the opening of branches than by the chartering of new banks. The recent upswing of this movement beginning in 1953 was due principally to the growth of economic activity. Other contributory factors in recent years include managerial difficulties such as the shortage of experienced personnel and the realization of the importance of scale economies.

The present Comptroller of the Currency, Mr. J. J. Saxon, has adopted an even more liberal attitude towards proposed bank mergers than his predecessor, Mr. R. M. Gidney. In doing so he has encountered rigorous opposition both from within the banking industry and from other regulatory agencies responsible for shaping the industry's structure such as the Antitrust Division of the Department of Justice. The views of these three groups regarding mergers are set forth below.

Mr. Saxon

Mr. Saxon, aware of the criticism placed upon the lenient policy in approving bank mergers of his predecessor, was also aware of the rapid growth and development of the United States economy. The banking industry, being the main generator of business enterprise, must grow in order to meet the needs of the nation. His strong belief in industrial expansion, whatever form it may take -- new charters, new banks, mergers, and holding companies -- has been practiced during his term of office. He adopted the merger device for expansion due to the regulations in several States restricting new charters and branches. He approved eighty mergers in the year 1962 as compared to Mr. Gidney's average of seventy-four a year during his term of office from 1953 to 1961. Mr. Saxon approved 139 mergers from

November, 1961 through December, 1963; 76 percent of these took place in States with limited area branch banking, 19 percent in States with statewide branch banking, and only 5 percent in States which prohibit branch banking.

Mr. Saxon expressed his views about the need for bank expansion in an address before the National Credit Conference of the American Bankers Association, Chicago, Illinois, on January 22, 1963:

> As our economy has grown, it has become increasingly evident that the commercial banking system occupies a central role in its progress. It is upon the commercial banking system that we significantly rely for the marshalling and disposition of our capital resources, and the provision of our payments mechanism. A deficiency in financial mechanism will critically affect the rate of our economic growth.

Mergers are generally approved in the States where State Law prohibits branches. The growing demand for branches accelerated the merger movement. Merger of banks to create branches eases the banks' most difficult current problem, that of large migration of population from metropolitan to suburban areas. This shift in population creates not only a need for new banking offices but a possible shift in the relative importance of various services performed and hence in the types of offices needed. This leads metropolitan banks to follow their customers and to open offices for the convenience and needs at the place of their domicile. The shift has affected the bank's earnings in two ways: firstly through a drain on deposits which raises the capital-deposit ratio, and secondly through the shift of the loan business of the depositors to the local banks of their domicile.

In absence of free entry in the banking industry and restrictions on branch banking in several states, the expansion of the banking industry was at stake. Existing banks, with no fear of new entry, enjoy monopoly power in their respective market areas. According to a study prepared by the Commission on Money and Credit, 40,000,000 people live in one bank towns. These people cannot enjoy the complete range of banking services from the small unit banks. The expansion in any form it may take, branches, new charters, merger or holding company was considered necessary. Every form of bank expansion was criticized for fear of adverse competitive effects, without realizing the need of adequate banking facilities.

Mr. Saxon does not only consider the convenience and need of the community under the growth of the economy, but also realizes the importance of the strength of the banking industry and examines the economic factors involved in individual merger cases. Cost advantages obtained from large scale banking operation are one of the factors considered in such cases. Economies of scale are due to size of the plant rather than size of the firm. Multiplant operations in the banking industry, i.e. branch banking, result in lower costs, when larger banks are created or facilities are shared between branches.

Department of Justice

The merger movement since 1953 has been opposed by the Justice Department on the grounds of creating monopoly or lessening competition. Antitrust Laws are applied to the banking industry. Other industries are subject to governmental regulations and control to the same extent as commercial banking. In those cases they are usually exempt from the Antitrust Laws in matters subject to regulation. In the banks there are limitations on the rates of interest which they may pay on time and savings deposits; they are prohibited from paying interest on demand deposits; they are limited by the usury laws in the interest which they may charge on loans.

The supply of loanable funds which is the bank's stock in trade is limited: (1) by the amount of deposits they are able to generate; (2) by the reserves they are required to keep with the Federal Reserve System; (3) by the amount of total supply at any given time; and in many other respects. The Board of Governors of the Federal Reserve System has several methods including setting of reserve requirements and discount rates and open market operations, which it can and does use to influence the money supply. It is not within the power of the banks, as is true of industrial corporations, to increase freely their productive capacity or the price of their output. In spite of these regulatory restrictions there can exist monopoly prices in the commercial banking industry as it operates in the United States today.

Section 7 of the Clayton Act and Sections 1 and 2 of the Sherman Act, applied to the banking industry in several merger cases by the Antitrust Division of the Justice Department, fail to recognize the unique position of the banking industry.

Mr. Saxon pointed out the consideration of legal issues involved which were of long-range significance to the banking industry.

> . . . and particularly on the issue of the basic clash between the fundamentals of the banking structure as determined by the Congress of the U. S. with respect to National banks, namely, the preservation of solvency and the basic tenet of the antitrust laws which is the preservation of competition.[1]

The Justice Department would prevent mergers and branch banking development on the basis of the drawback of this approach to the problem of banking competition. Paul M. Horvitz, describing the present state of competition as unsatisfactory, said:

> We would remain with the banking system consisting of thousands of small banks. This is a desirable approach if one is satisfied with the present state of competition in banking. If, on the other hand, we feel that banking could be more competitive, that there are too many communities with no banks or with only one bank, or that there are significant economies of scale in banking, the antitrust approach is not optimal.[2]

---

[1] James J. Saxon, Hearing Before the Committee on Banking and Currency, U. S. Senate, Nomination of James J. Saxon, 87th Cong., 2d Sess., February 6, 1962, p. 8.

[2] Horvitz, loc. cit., pp. 311-312.

State Banking Authorities

Mr. Saxon's policy of expansion and his proposal to facilitate National banking system to open branches even in the States prohibiting branches, has raised objections by the State banking authorities. They fear that Mr. Saxon's expansion through branches, whether "de novo" or by merger, threatens drastic changes in banking policy and the destruction of the one hundred year old U. S. dual banking system. This liberal policy would drive the unit banks out of business with the concentration of power in the hands of a few large branch banks. Mr. Saxon replied to these fears in a 1962 address:

> The objective of public policy should be -- not to safeguard banks of any particular size, but to assure that the public's needs are met to the best advantage, by whatever institutions can do the job most effectively. There is a point beyond which the cost advantages of large-scale operations will be exhausted, or will not be passed on to consumers because of diminished competition. But until that point is reached, no arbitrary, absolute limit should be placed upon the expansion of banking facilities.[1]

The Independent Banker's Association fears that in the merger resulting in large branch banks competing with small unit banks, it is possible that the unit bank could be forced out of business due to operating economies and greater facilities offered by the branch. Mr. Saxon, commenting on this fear, said:

---

[1]James J. Saxon, "What Kind of Banking Structure Do We Need: The Role of Branch Banking," loc. cit.

> The capacity of banks to survive competition is not solely dependent upon the scale of their operations. For many banking services, size confers no advantages. Moreover, our experience shows that well-managed, adequately capitalized, aggressive smaller institutions can prosper and progress alongside the largest banking institutions.[1]

The merger activity resulting in large branch banks helps to strengthen the unit bank to compete more effectively with branch banks. The unit banks is not hurt by entry of branches, but the damage to unit banks is done by loss of its monopoly position rather than by the cost advantages of branches.

Evaluation

We shall examine the position taken by Mr. Saxon on mergers and, for the sake of comparison, that held by the Department of Justice and the Independent Bankers Association from three different but interrelated viewpoints. Firstly, do their merger policies tend to reduce or increase competition? Secondly, is the implementation of Mr. Saxon's policies in United States banking creating an industry structure which better serves the requirements of public convenience and necessity than the structure it is replacing or that advocated by the other groups? Thirdly, do the changes occurring in the demand for banking services justify this policy?

Competition may be regarded as an end in itself which is

---

[1] Ibid.

to be fostered even though in some circumstances it can be shown to lead to a sub-optimum allocation of goods and services compared with alternative distribution systems, such as central planning at one polarity or distribution through kinship ties at the other. Alternatively competition can lead the economy towards an optimum allocation of resources when certain conditions are met.

Even when some of the theoretical requirements of the perfectly competitive model are absent, it is possible to create a legal and institutional framework which modifies the forces of market competition to produce a similar social result to that observed when they are present.

One notable departure of the banking structure from the perfectly competitive model is the lack of freedom of entry. With numbers entering the industry controlled by the State Banking Commissions and by the Comptroller of the Currency, in the case of banks with national charters, an important determinants of the vigor of competition is under regulatory control. Where a large range of bank sizes can operate at a profit, permitting merger and/or allowing new entrants into the banking sector enables the regulatory body to direct the growth of the industry towards a workably competitive structure. Competitiveness in banking need not necessarily be an increasing function of the number of banking firms per million people. The Independent Bankers Association and the Antitrust Division have tended to view the accelerated merger movement sanctioned by Mr. Saxon as being antithetical to the encouragement of competition.

Many small banks operating in geographically isolated markets, e. g. one bank towns, are less responsive to market forces than fewer banks with overlapping market areas. The branch form is particularly suited to increasing the competitiveness of the industry without necessarily increasing concentration ratio. Branch banks introduce competitive prices in monopolistic markets, as the rates are determined by the head office usually in metropolitan areas where banks have more competition. These competitive banks are more responsive to changes in monetary policy. Branch banks tend to adjust their policy quickly to changes in supply conditions as well as changes in demand throughout their market, while unit banks may react more slowly in the local market areas, particularly when the supply of funds increases and free market rates tend to fall.[1] Large scale operation means lower cost production. As the bank increases in size the lower cost is passed on to consumers. This cannot be done in small banks operating in geographically isolated markets.

In order to increase the competition in the banking market, it is the nature of the regulation which requires modification rather than the imposing of antitrust laws on this industry.

The most important change in the policy would be to permit

---

[1] "Banking Structures and Reactions to Monetary Stringency or Ease," loc. cit.

freer entry. This would involve making new charters available on a less restrictive basis than is done on the current "need and convenience" criteria, removing arbitrary limitations on de novo branching and branching by mergers. Efficient independent banks and those smaller banks which offer differential services for which there is market demand would not be forced from market by these changes. In efficient banks would have to improve their efficiency, merge, or fail; the market power of locally monopolistic or oligopolistic banks would be effectively constrained.

The changes occurring in demand for banking services, due to increasing population and structural and locational shifts of industry and population from metropolitan to suburban areas, do not only need new banking offices, but also a shift in various services performed and hence the types of offices needed. With the barrier on entry and restriction on branches to supply the type of services needed, the merger device was adopted to fulfill the convenience and need of the growing communities. The merger is not the only way to extend servi ces; Mr. Saxon, wherever law permits, liberalizes the policy to open branches in needed areas. In his view, to increase competition in the banking industry is to remove the legislative barrier to new entry and liberalize the branch banking policy. To prohibit mergers which tend to lessen competition is a difficult standard to apply. There is danger that this policy could evolve into protection of small and inefficient competitors rather than a policy to promote competition. An extremely strict merger policy would make it difficult to realize scale economies and the benefits of freer entry. Mr. Saxon feels that to improve the performance of commercial banking is essential. It appears, however, that the role of conventional antitrust policy -- the prevention of mergers and combinations in restraint of trade -- in achieving the result is an extremely limited one due to public regulation and supervision.

In conclusion, it is seen that the merger movement in banking corresponds to the growth of larger firms with nation-wide marketing and/ or production facilities in other sectors of the economy, of industrial congolomerates which cannot be identified uniquely with any one sector, and of rising per capita incomes and increased demand for credit and other banking services. The branch form of banking emerging as a result of a more liberal policy towards mergers brings the benefits of competition to consumers living in areas where inter-bank competition is infeasible and provides a wide range of banking service without the scale diseconomies of a large unit bank.

BIBLIOGRAPHY

Books

Alhadeff, D. A. Monopoly and Competition in Banking. Berkeley: University of California Press, 1954.

Bain, J. S. Industrial Organization. Berkeley: University of California Press, 1959.

Chapman, J. M. and Westerfield, R. B. Branch Banking. New York: Harper, 1942.

Gramley, L. E. A Scale Economies in Banking. Federal Reserve Bank of Kansas City, 1962.

Horvitz, P. M. Concentration and Competition in New England Banking. Boston: 1958.

Malanos, G. Intermediate Economic Theory. New York: J. B. Lippincott Company, 1962.

Nadler, M. The Banking Situation in New York State. New York: The New York State Bankers Association, 1940.

_____ and Bogen, J. The Banking Holding Company. New York: Graduate School of Business Administration, New York University, 1959.

Neale, A. D. The Antitrust Laws of the United States of America: A Study of Competition Enforced by Law. Cambridge University Press, 1960.

Reed, E. W. Commercial Bank Management. New York: Harper & Row, Publishers, 1963.

Steiner, W. H. and Shapiro, E. Money and Banking. New York: H. Holt & Company, 1946.

Weston, J. The Role of Merger in the Growth of Large Firms. Berkeley: University of California Press, 1953.

Theses

Bogen, J. I. The Competitive Position of Commercial Banks. Graduate School of Business Administration, New York University, 1959.

Hayes, W. G. A Study of the Procedure in the Consolidation of National Bank. Graduate School of Banking, 1955.

Journal Articles

Abramson, V. "Private Competition and Public Regulation," The National Banking Review, Volume 1, Number 1 (September, 1963).

Alhadeff, C. B. and Alhadeff, D. A. "Recent Bank Mergers," The Quarterly Journal of Economics (November, 1955).

________., D. A. "Bank Mergers: Competition versus Banking Factors," Southern Economic Journal (January, 1963).

________. "A Reconsideration of Restrictions on Bank Entry," Quarterly Journal of Economics (May, 1962).

Balles, J. J. and Eastburn, D. P. "Bank Lending Policies in Period of Monetary Restraint," Money and Economic Activity: Reading in Money and Banking, Boston: Houghton-Miffin Company, 1961.

"Banking Structure and Reactions to Monetary Stringency or East," Monthly Review, Federal Reserve Bank of Kansas City (March-April, 1964).

Business Week, February 12, 1955.

Carson, D. and Cootner, P. "The Structure of Commercial Banking in the United States," Private Financial Institutions, A series of research studies prepared for the Commission on Money and Credit, Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1963.

________ and Horvitz, P. M. "Concentration Ratios and Competition," The National Banking Review, Volume 1, Number 1 (September, 1963).

"Changes in Banking Structure, 1953-1962," Federal Reserve Bulletin, Volume 49, Number 9 (September, 1963).

"Comptroller's Decision in the Westchester Merger," Banking (February, 1962).

Crutchfield, J. A. and Hold, E. C. "Economic Expansion and American Banking System," Journal of Business (April, 1956).

Edwards, C. D. "Preserving Competition vs. Regulating Monopoly," American Economic Review, 1940.

Federal Reserve Bulletin, 1953-1963.

Horvitz, P. M. "Economies of Scale in Banking," Private Financial Institutions, a series of research studies prepared for the Commission on Money and Credit, Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1963.

________. "Branch Banking, Mergers and Competition," Banking and Monetary Studies, Homewood, Illinois: Richard D. Irwin, Inc., 1963.

Motter, D. C. "Bank Mergers and Public Policy," The National Banking Review, Volume 1, Number 1 (September, 1963).

New York Times, 1953-1963.

Robinson, R. I. "Priorities in the Use of Bank Funds," Money and Economic Activity: Reading in Money and Banking, Boston: Houghton-Miffin Company, 1961.

Saxon, J. J. "Non-Branching Policy -- A Formula for Stagnation," The Commercial and Financial Chronicle (April 25, 1963).

________. "What Kind of Banking Structure Do We Need: Role of Branch Banking," Address before New York Financial Writers Association, May 27, 1963.

Shull, B. "Commercial Banking as a 'Line of Commerce,'" The National Banking Review, Volume 1, Number 2 (December, 1963).

________ and Horvitz, P. M. "Branch Banking and Structure of Competition," The National Banking Review, Volume 1, Number 3 (March, 1964).

U. S. News and World Report, November 25, 1963.

Wall Street Journal, 1963-1964.

Public Documents

U. S. House of Representatives. Committee on Banking and Currency. Conflict of Federal and State Banking Law. 88th Cong., 1st Sess., 1963.

U. S. House of Representatives. Committee on Banking and Currency. Regulations of Bank Mergers. 86th Cong., 2d Sess., 1960.

U. S. House of Representatives. Committee on Judiciary, Subcommittee No. 5. Bank Mergers and Concentration of Banking Facilities. 82nd Cong., 2d Sess., 1952.

U. S. Senate. Committee on Banking and Currency. Nomination of James J. Saxon. 87th Cong., 2d Sess., 1962.

U. S. Senate. Committee on Judiciary, A Staff Study of the Subcommittee on Antitrust and Monopoly. Corporate Mergers and Acquisition. 85th Cong., 1st Sess., 1957.

Reports

Board of Governors, Federal Reserve System. Annual Reports for the Years 1952-1962.

Comptroller of the Currency. Annual Reports for the Years 1952-1962.

Federal Deposit Insurance Corporation. Annual Reports for the Years 1952-1962.

Typed: Nancy McLain

Multilithed: Margaret Pluid