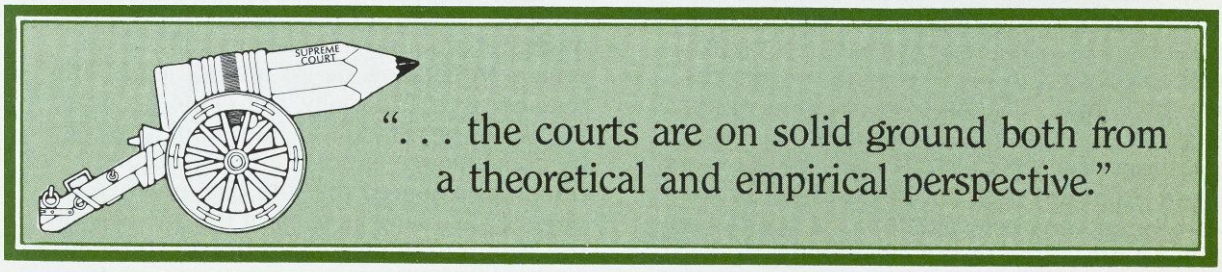
CONCLUSION

Our review of the relevance of the court's treatment of commercial banking as a separate line of commerce indicates that the courts are on solid ground both from a theoretical and empirical perspective. On a theoretical level, either a unique product or the fact that a significant group of consumers view the array of products offered by commercial banks as a cluster of services is sufficient to distinguish the product offered by banks from that offered by suppliers of other financial services. On the empirical side, we found that some small businesses obtain all their financial services from their local commercial bank.

The Monetary Control Act expanded the types of financial services which thrift institutions may supply to consumers and corporate customers. The unique position that commercial banks once enjoyed for consumer and corporate third party transaction services, demand deposit accounts, and commercial loans no longer exists. Effectively, the only unique position still enjoyed by commercial banks is the ability to offer third party transaction accounts to corporate customers.

To a large extent the courts' rationale for separating the product of commercial banks from that of all other suppliers of financial services for antitrust purposes has historically hinged on the uniqueness of commercial banks offering third party transactions accounts and financial services for small, locally constrained commercial customers. Because of the Monetary Control Act and the revolution within the financial services industry in recent years, this distinction between commercial banks and other types of financial institutions is brought into question.

Using the courts' criteria, we found empirical evidence that there are significant actual or potential alternative sources for each of the financial services offered by commercial banks. The legislative monopoly awarded to commercial banks as a group for offering business



"Because of the Monetary Control Act and the revolution within the financial services industry in recent years, this distinction between commercial banks and other types of financial institutions is brought into question."

checking accounts was found to be sufficient in and of itself to meet the court's criterion for separating commercial banks' product from the product of all other suppliers of financial services.

We also found that for most commercial services offered by commercial banks, there are significant alternative suppliers. We can argue over the term "significant," but all the empirical evidence points to the fact that alternative or potential alternatives exist for most of the individual services offered by commercial banks. The court's criterion, however, centered not on the availability of a single service, but on the availability of the cluster of services offered by commercial banks to a specific set of customers. New empirical evidence indicates that small businesses do indeed use a number of financial services (4.7 on average) and that they tend to obtain the vast majority of these services from local banks.

In short, the evidence supports the view that an identifiable proportion of businessmen operating small businesses obtain a number of financial services from local banks, or behave as if the commercial banks clustered their services. Again, in light of the evidence and the courts' criticism, it is still relevant to view commercial banks as offering a separate line of commerce.

The Supreme Court's definition of the product offered by commercial banks as a cluster of services implies that there are forces which encourage bank customers to view the cluster of services as a single product. There are at least three ways in which a group of services may be joined. First, suppliers of services may establish tie-in arrangements requiring the purchaser of a service to buy all services in the cluster from the supplier. Any number of services and any combination of services may then be presented to the customer as a cluster. Second, users of the services may find it more convenient to purchase all needed services from a single provider. This would effectively cut down on search and information costs to the customer. Or third, offering a wide array of services may allow the suppliers to take advantage of any agglomeration economies or economies of scale which may serve to lower the cost of any individual service to the customer.

Under these circumstances, commercial banks may be capable of providing the clustered services at a lower price than a single service provider.

In addition, although commercial banks are unique among financial service suppliers in being able to offer commercial third party transactions accounts, they are prohibited from paying interest on these funds. Therefore, commercial banks must compete among themselves for corporate demand deposits by offering greater convenience, or reducing prices on services. This may mean presenting their array of services as a package or cluster. Reduced prices on any single service or the entire cluster would reduce the implicit cost to the commercial customer of holding non-interest bearing demand deposits. This is the economic rationale for commercial banks offering a cluster of services to small businesses. At the same time, it may explain why small businesses view the commercial bank services as a package or cluster.

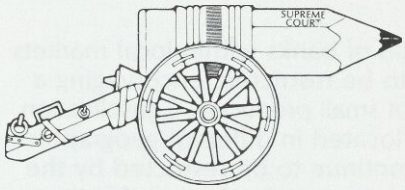
Direct empirical evidence on the question of clustering of services is very difficult to obtain. In banking, tie-ins are not legal. They may be used informally, but evidence of tie-ins would be difficult to find. Joining services by convenience almost certainly occurs. It has often been argued that the convenience of one-stop banking links all of the services of the commercial banks and has given banks a

substantial advantage in competing with other suppliers of individual services. The best evidence to confirm or deny this type of clustering would be an empirical finding that many consumers use a number of financial services offered by the commercial bank. In other words, do customers behave as if the services supplied by commercial banks are clustered?

Each of the three empirical studies on this question found evidence consistent with the assertion that small businessmen behave as if they perceive commercial bank services as a cluster. In addition, the Sixth District small business survey found that some 35 percent of the small businesses using financial services obtained from banks obtained all of their financial services from banks. In light of the Supreme Court's focus on the probable anticompetitive effects of mergers and acquisitions on a significant group of customers, the 35 percent may be viewed as a significant group of customers and used to assert the validity of the courts' view of banking as a separate line of commerce.

The reader should be cautioned, however, because the same survey showed that 51 percent of the small businesses using financial services from commercial banks also used financial services supplied by nonbanks. The fact that there are alternatives for almost every service provided by commercial banks supports the view that these alternative suppliers may have some competitive impact on price and output decisions of commercial banks. The purpose of the competitive standards in the Bank Holding Company and Bank Merger Act, as well as our antitrust laws generally, is to avoid reducing competitive pressures. To the extent that nonbank suppliers of financial services influence the pricing decisions of commercial banks, either for the cluster of services or for any individual service, they should be viewed as competitors and included in any competitive analysis.

The regulatory authorities and courts have consistently appraised the competitive impact of nonbank suppliers on a case by case basis. Denials of acquisitions and mergers have been handed down in rare cases based on substantial anticompetitive effects on a given service line, such as trust services. The empirical evidence suggests that nonbank alternatives for financial services supplied by commercial



banks are growing in significance and both market forces and new legislation are expected to heighten this significance.

Although the evidence presented to date is probably not sufficient to cause the courts to redefine the commercial banks' product, the time is right for the regulatory agencies to emphasize certain service lines in their analysis of bank merger and acquisitions. Following the MCA, all consumer financial services offered by banks are also offered at a number of other financial institutions. Therefore, anticompetitive consequences of bank mergers or acquisitions are less likely to affect this group of customers than business customers. As a consequence, the regulatory agencies should focus on those services provided by banks to business customers. If the agencies find that a merger or acquisition would have substantially adverse competitive consequences on the market, a denial recommendation would be supportable in the courts under our present antitrust laws.

Assuming the courts and regulatory agencies do not change their criteria for defining relevant products for antitrust consideration, our findings are consistent with the courts' present treatment of banks as offering a separate product in local markets. Neither the recent legislative changes nor the new realities of the market place are sufficient to encourage a change in the way the courts view commercial banking.

> "Although the evidence presented to date is probably not sufficient to cause the courts to redefine the commercial banks' product, the time is right for the regulatory agencies to emphasize certain service lines in their analysis . . ."

Consolidation of banks within local markets will continue to be restricted, encouraging a large number of small producers. Consolidation among banks located in different geographic markets will continue to be restricted by the prohibition of interstate banking at this time. Unless we get new legislation, commercial banking will continue to be an industry composed of a large number of competitors, while other types of financial institutions continue to consolidate.

Based on the evidence presented here, however, it is likely that in the near future commercial banking as a separate line of commerce may cease to be relevant for antitrust purposes or as a market place reality. The evidence suggests that the financial market place is changing, and that small businesses are turning increasingly to nonbank institutions for some of their financial services. The once exclusive position enjoyed by commercial banks is coming to an end.

In addition, new technology and the development of new services by nonbank financial institutions is undermining one of the critical pillars supporting the separability of banks from other types of financial institutions, i.e. the convenience element. With the development of in-home computers which may be linked via cable television to financial institutions, financial services of all types will be as close as your television. This will surely undermine the notion that consumers or small businesses are limited to their local area for financial services.

These market changes will force legislative changes which inevitably will result in a new financial infrastructure. As George Benston has pointed out, we should have no fear that a repeal of the 1930s legislation limiting geographic and product segmentation will result in an unsafe or unstable financial system. Market forces of the 1980s will force these changes.

The real questions now are how soon these changes should come and what type of financial infrastructure do we need. The answer to the first question is apparently that market forces have not pushed us to this point yet, but are likely to in the near future. Thus, we must now understand that change is coming and plan for it. We need more research to answer the second question concerning the financial infrastructure necessary in the decades ahead. These questions will be the subject of future issues of this **Review**.

—David D. Whitehead

Conclusion

A wave of market forces, including the trend toward financial conglomerates, the success of the money market mutual funds, and the crisis in the thrift industry, has increased interest in the question of interstate banking. Should we allow interstate banking? What type of interstate banking should be allowed? Should we change the Douglas Amendment or the McFadden Act? If the prohibitions are removed, how quickly will interstate banking occur and what form will it take? How disruptive is it likely to be moving from a market structure mandated by geographic prohibitions to a structure free of these prohibitions? What are the potential private and public benefits and costs associated with such freedom? This special issue of the Review addressed a number of these questions in an attempt to further understanding of the issues. What, then, may we conclude?

First, we found that the largest bank holding companies have already established a sizable interstate presence through nonbank subsidiaries.

Many of the holding companies are headquartered in the Northeast and have established interstate offices, mainly in high growth and densely populated states. These same states attractive for nonbank entry will prove to be the most attractive areas for interstate banking should the prohibition be lifted.

Given what these large holding companies have already obtained, they appear to have little incentive to establish vast nationwide interstate systems of acquired banks seeking to attract relatively marginal accounts. This will become increasingly true as banks come under competitive pressure to pay market rates for these accounts. Given these factors, interstate banking is likely to proceed slowly and to be concentrated geographically if the prohibitions are removed.

Market forces have propelled us into an interstate financial world. Many financial services are currently available on an interstate basis and new financial sevices that know no geographic restrictions are being developed almost daily. As has occurred in the past with most major banking legislation, market forces are necessitating legislative change.

Finding the right bridge to an interstate banking system will be complex. A number of advantages are associated with allowing interstate banking through the branching route or through the establishment of banks. And further, there are advantages and disadvantages to be considered in allowing **de novo** expansion or expansion through acquisition. The specific approach to interstate banking must also find a way to deal with interstate financial services that have developed or will develop even without legislative changes.

Interstate Tide Will Be Slow

Even without legislative mandates, the development of interstate banking systems most likely will be slow. As we have seen, banks enjoy no great cost advantages as they increase in size. Therefore, potential cost savings will not be a driving force behind interstate expansion. Empirical research also indicates no substantial scope economies in banking. These two elements imply that smaller local banks have relatively little to fear from larger interstate competitors in terms of cost disadvantages.

Interstate banking will not spell the end of such local banks. As long as these banks are providing services consumers desire they will remain in the marketplace. They may not be able to offer all the services provided by an interstate system but, as the Canadian experience indicates, there is a good deal of potential for them to remain competitive by offering customized banking services.

On another front, it was shown that the way we regulate bank capital will also tend to slow the development of interstate banking systems. While many community and smaller regional banking organizations have excess capital under current guidelines, the capital positions of larger regional holding companies and the multinationals seem to be weaker. Interstate expansion by the largest banking organizations may be somewhat restrained by capital considerations, but the medium and small sized banks are in a better position to meet the capital guidelines. The smaller organizations, then, not only have a reason to expand interstate but they also have the capacity to do so.

The market's assessment of interstate banking's potential profitability is important because it will affect the cost of raising new equity capital to support interstate expansion. As we have

seen, there is little reason to believe that interstate organizations will be substantially more profitable than noninterstate organizations. Quite the contrary, nationwide brick-and-mortar facilities established to collect marginal accounts at money market rates may in fact reduce profits, limiting an organization's ability to expand.

The form and pace of interstate banking also will be influenced by technological considerations. It was shown that the elements of an interstate retail electronic banking system are already in place. However, even on this front the hazy legal status of shared nationwide systems and apparent consumer reluctance will slow its development.

The Canadian experience demonstrates that interstate branching may assist in movement of funds and convenient access to funds and standardized financial services for large customer groups. Something may be lost, however, in terms of an interstate system's ability to respond or relate to small localized consumers. The Canadian example is instructive, but the interstate system that develops in this country will not mirror the Canadian system. We have already developed many relatively small institutions; there is little compelling reason to believe they will disappear.

Another certainty is that banking lobby groups will ensure that all aspects of the interstate question receive serious review by legislators. This is as it should be. A sound and competitively viable banking industry will be ensured only if all aspects of the issue receive adequate review.

A wave of market pressures will force legislative review of the interstate banking issue. These include the phaseout of Regulation Q, introduction of mandatory reserve requirements on all financial institutions holding transaction balances, the ability of banks and thrifts to offer new accounts paying money market rates, states individually passing reciprocal agreements to allow entry by out-of-state banking organizations, and the perceived increase in competitive pressures from nonbanks. Another wave of developments favorable to interstate banking involves troubled institutions. This wave includes the Board of Governors' decision to allow bank holding companies to acquire S&Ls across state lines, the Federal Home Loan Bank Board's decision to allow S&Ls to acquire troubled associations across state lines, and the Garn-St Germain Act's emergency provisions allowing interstate acquisition of troubled thrifts and banks.

Shaping A New Structure

Some form of interstate banking is inevitable; in fact, it is occurring today as states indivdually pass reciprocal agreements. The major issue no longer revolves around the question of whether or not to move to interstate banking; the major issue is how to move to a banking structure freed of geographic constraints.

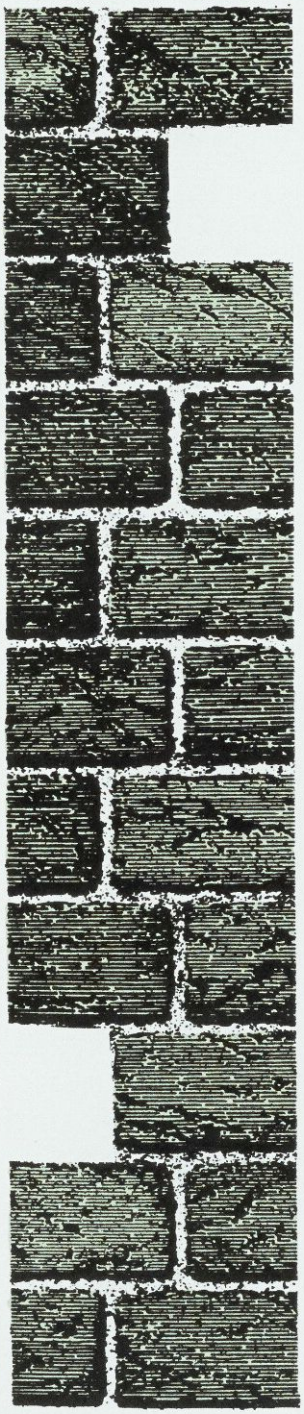
A major concern of legislators will be the market consequences of removing interstate prohibitions. Will removal of the prohibitions substantially increase the concentration of financial resources. The net effect of this increase, however, is likely to be marginal.

As we have seen, even though current antitrust laws would do little to prohibit market extension mergers, the largest banking organizations will face both regulatory and market imposed constraints on their ability to expand their interstate presence. Removing interstate prohibitions would result in a rather slow evolution toward a new market structure. This slow evolution will help ensure that a number of interstate organizations will develop not only from the ranks of the money center organizations but also from the ranks of medium and large regionals that have both the capacity and desire to expand interstate.

At the same time, no compelling reason was uncovered to suggest that small banks would be at a competitive disadvantage in local markets. From the standpoint of concentration of financial resources or maintenance of competitive markets, there appears to be little to fear from removal of the interstate prohibition.

Should we remove the McFadden or Douglas prohibitions, or perhaps both? Our research found no serious or substantial economic reasons to prefer removing one over the other. Establishing an interstate system of banks, however, would result in fewer regulatory changes both at the state and federal level and would not upset our dual banking system to the extent a branching network would. Therefore, changes in the Douglas Amendment to allow interstate banking would seem to be the path of least resistance.

Conclusion

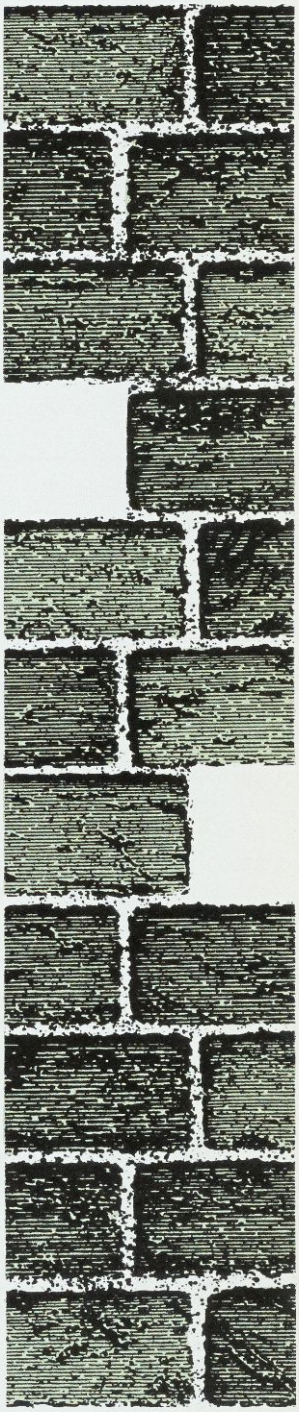


This **Review** has analyzed the consequences of expanding the array of financial products commercial banks may offer. The important questions are the impact of product deregulation on the safety and soundness of the banking system and on the concentration of financial power. The material here indicates there is little to fear from deregulating the financial products banks may offer. Indeed, there may be benefits for bank customers.

Safety and Soundness

This issue analyzed the potential risks to banks both of adding activities and of failing to add activities. The appropriate concern when considering the potential risk of allowing an additional activity is not the activity alone, but how the activity contributes to total risk exposure of the bank. A review of the relevant literature suggests that some new financial activities actually have the potential to decrease the risk exposure of banks. The literature also shows that acquisitions of financial firms do not necessarily change the acquiring firm's risk.

Management of the new activities determines whether potential risks become actual. Banks may already take substantial risks on their loans, securities, futures and options dealings, maturity matches and many other types of activities. U.S. banks engage abroad in many ventures forbidden at home. The evidence shows that U.S. banks have generally—not always—managed these risks competently. There is little reason to expect that managements will mismanage new domestic risks. New activities can be managed in a manner that will stabilize or even diminish risk to the individual bank and to the financial system. Providing incentives to limit risk is a crucial consideration. Today's deposit insurance and discount window arrangements actually provide incentives for risk by reducing the exposure of both depositors and shareholders. Adjusting these environmental factors to shift the risk on to the private sector would impose useful market discipline. These issues are already being widely discussed, so we have not focused on them here.



Failure to deregulate carries its own risk. Firms offering insurance, investment banking and real estate services are already invading the traditional financial service markets of banks, while banks are constrained from offering these traditional products. If less regulated firms are able to attract significant amounts of bank liabilities to less-regulated sectors, the financial system's safety and soundness will be reduced. Ensuring both intermediation and payments is important. Although nondepository contenders pose little threat to either of these systems in the short run, in the longer run, larger shifts of deposits and payments activity into less regulated sectors could weaken the safety of the financial and payments systems. Allowing banks to compete more broadly might delay or prevent that prospect.

Concentration and Competition

Proposals to broaden banks' permitted activities also have raised concerns about concentration of economic resources and competition. Overall, however, concentration, tie-in requirements and conflicts of interest apparently would be reduced, not encouraged,by the relaxation of product restraints on banks. Many competitors from several industries would be vying for financial services business. New entrances are generally more innovative and market-sensitive.This would increase the number of alternatives available, encouraging competition, and decreasing economic concentration.

Fears that cross-industry mergers will concentrate political and social power still trouble some regulators and economists. Policymakers lack hands-on experience with the potential structural changes resulting from broad financial deregulation and are not entirely sanguine about its ultimate effects on financial power. Laws limiting the size of cross-industry mergers would limit any natural tendencies toward concentration, if they exist. Size limits for merging firms would have to be considered carefully to ensure that they gave no advantages to firms that are already large and that they did not unduly limit firms' ability to increase efficiency by capturing economies of scale and scope.

Current laws, regulations and market factors serve to limit significant increases in concentration. The evidence suggests that concern about conflicts of interest and tie-ins are largely unwarranted. Users of financial services would be able to spurn financial organizations that demanded unreasonable tie-ins because deregulation should actually increase, not reduce, the number of alternative suppliers of financial services.

Customer Benefits

Surveys indicate that users of financial services desire broader product offerings from financial institutions. The public apparently believes it would benefit from some removal of activity limits. This expected benefit must be balanced against broader concerns about safety and concentration, of course. We surveyed household customers on their reactions to broader powers. Households generally responded positively. Those in the lower-and middle-income groups affirmed a stronger preference for making a wide array of product offerings available at single institutions. High-income consumers place a premium on receiving financial advice and information from a broader range of suppliers. Some households expressed strong preference for a commercial bank as their full-service provider. Asked what services they would like to see added to banks' present capacities, consumers indicated a preference for insurance, and stock and real estate brokerage services.

An analysis of probable business reactions to broader bank activities indicated that they would like to see an increased range of bank products, including management of comingled funds and, for some smaller firms, securities underwriting and retail distribution. Larger firms do not consider securities underwriting by banks to be particularly necessary. Judging from the evidence, current limits on banks' securities and underwriting business apparently have little impact on these businesses.

Lessons from the Securities Industry

Banks' current activities in the securities industry exemplify at least three things about product limitations: First, product limits may increase risk-taking as well as reduce it. Limits on banks' underwriting and trading activities, for example, may limit banks' ability to offer the narrow range of permitted securities services profitably. Second, product limitations may reduce banks' ability to serve customers. Securities

limitations apparently make it difficult for banks to provide the full services necessary to establish ongoing relationships with wholesale customers. Finally, removal of product limits need not mean that banks will increase substantially their share of new markets. For example, banks have fared poorly in securities activities for cultural reasons, in addition to regulatory restrictions.

Summing Up

Skeptics express concern that further deregulation could increase banks' and the financial systems' risk, spawn conflicts of interest or allow a dangerous concentration of financial power. This **Review**, however, has shown little threat that the banking system would be undermined by permitting banks to diversity into a broader range of activities. Most bankers have shown themselves to be competent and they will remain competent if regulatory prohibitions are relaxed. Capable managers can conduct potentially risky ventures safely, just as irresponsible ones can make "safe" activities hazardous. Reform of deposit insurance and the discount window,currently being debated, would help discourage bankers from taking inappropriate business gambles.

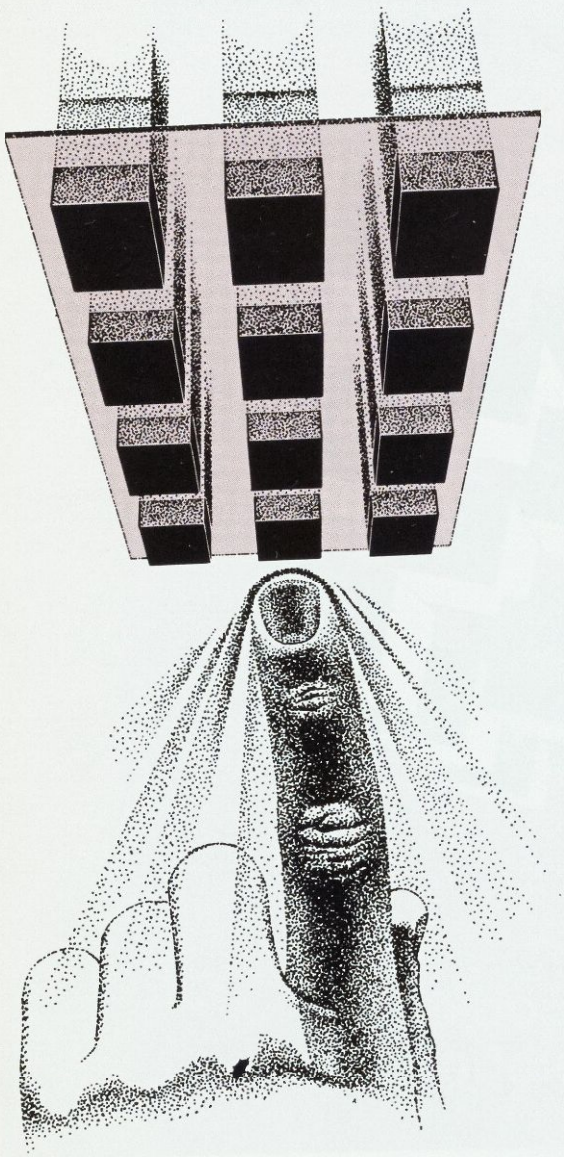
On balance, customers would benefit from an expansion of the products commercial banks are permitted to market. Customers for financial services would be likely to benefit from stimulated competition if banks were allowed to diversify into such areas as securities brokerage, insurance and real estate. Further, some customers expect to benefit from being able to buy more financial services from the same institution.

Conclusion

The Revolution in Retail Payments: A Synthesis

Bernell Stone

Computer technology has triggered a revolution in retail banking, but a host of obstacles stand in the way of a rapid transformation



Much has been covered in this workshop. To synthesize and yet remain brief, I will comment on retail banking as part of the overall retailing revolution, highlight economic issues, and then summarize key points on the three major subjects we have addressed—ATMs, POS-based direct debit systems, and home banking.

The Latent Retailing Revolution

Central to our discussions has been the fact that existing computer technology holds the potential to revolutionize a major portion of retailing. This revolution goes far beyond payments and the services traditionally within the province of commercial banks.

At the center of this revolution is an electronic interface to the consumer. Computer-based catalogs are an alternative to stores and print catalogs for providing product information, taking orders for many products, and transacting sales. Electronic shopping can replace much of today's store-based shopping and change today's printed catalog into an enhanced electronic analog. Placing orders from electronic devices such as personal computers, special-purpose terminals, and possibly some hybrid of TV and telephone should also mean significant change in distribution, warehousing, and even production scheduling. On the retail side there may be changes in payment practices and the consumer interface to banks. Moreover, part of the retailing revolution presents the opportunity to alter the distribution of bank and other financial services.

The Economics of Electronics

George Benston opened the workshop with an economic framework for viewing the issues. It is crucial to remember that change requires not just an available technology but a cost-effective bundling of the technology into products acceptable to the consumer.

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