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Statement of

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of the

Committee on Banking and Currency

of the

House of Representatives

on

S. 1698

and related bills

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Mr. Chairman, I thought it might be helpful to your deliberations if I offered a brief summary of my views on the substantive issues involved in commercial bank mergers. I will do this by reference to the cases considered by the Federal Reserve Board in the past 3-1/2 years--roughly the period of my service on the Board.

As both this statement and my voting record will testify, I regard the competitive impact of mergers the most difficult and complex question posed in bank merger cases; but I also believe that, when properly analyzed, competition turns out to be significantly affected in only a minority of bank merger proposals. When competition is significantly reduced I favor denial unless the bank to be acquired is an unsound operation or woefully inadequate to meet its community's needs.

Let me explain the reasoning that underlies this conclusion. The Bank Merger Act of 1960, under which the Board operates, requires the supervisory authorities to consider a set of seven factors in each merger case. The first five are called "banking factors." They cover such considerations as the financial history and condition, the adequacy of capital, the quality of management, and the earning prospects of the institutions involved. The relevant supervisory agency is to judge such questions as whether the status of the surviving bank is strong enough to support a merger or if the position of the bank to be merged is so weak as to impel one. Since banks involved in mergers usually are operating institutions and have their performance recorded in the form of statistical, examination and field contact reports, supervisory authorities, with such differences in judgment as reasonable men exhibit, have little difficulty in sorting out and evaluating the banking factors.

During the past 3-1/2 years the Board of Governors has considered 107 merger cases. It has approved 97 applications and denied 10.[1/] Banking factors were the major or a significant consideration in 44 approvals and 4 denials. The banking factor that most frequently represented a basis for approval was a needed improvement in management. In every case of approval except three where banking factors were of significance, the competitive factor was judged to be neutral or, on occasion, slightly adverse. In the three approved mergers where there was significant competition between the merging institutions, the acquired bank faced management, capital or earnings problems that the Board felt were sufficiently pressing to warrant their resolution by merger. On the other hand, in each of our 10 denials of merger applications during this period, the banking factors, even though of concern in four cases, were finally judged of lesser importance than the competitive factors in every instance.

The record makes clear that there are very, very few cases in which the competitive factor is significantly adverse but in which banking factors are nonetheless judged to provide an overriding reason for approval. Such fortunately rare cases typically involve a serious management breakdown, self-dealing or evident incompetence.

1/ I might add I have not seen eye to eye with the majority in all of these cases. I would have turned down 11 applications that were approved and approved one application that was denied.

As compared with the banking factors, the other two factors that supervisors are required to consider under the Bank Merger Act pose much knottier problems, both of information and analysis. The statute specifically refers to these factors as (1) "the convenience and needs of the community to be served" and (2) "the effects of the transaction upon competition, including any tendency toward monopoly."

How does one go about judging whether the convenience and needs of the community will be benefitted by a change in banking ownership and management? This involves determining the actual breadth and intensity of community demands for various banking services, as distinct from the quantity and quality of services that the existing and proposed new combinations of banks intend supplying. To do this one needs to survey community opinion on the status quo, to find out how both business and household customers appraise the quantity and quality of the banking services available to them.

But it is hard for bank customers to compare services they are accustomed to with those they have never had the opportunity to try out. Such survey results, therefore, must be supplemented by a more knowledgeable appraisal. In this appraisal, the broad experience of examiners in the qualitative and quantitative aspects of banking services can usually be helpful.

Another aspect of the impact of bank mergers upon the "convenience and needs of the community" concerns the contribution that banks can make to economic growth and stability in their own communities. A bank that is investing heavily in out-of-state business loans, tax-exempt securities, or mortgages contributes less to its community than one that is playing an active role in satisfying the credit needs of local businessmen, farmers, consumers and governments. Clearly, so far as the community's convenience and needs are concerned, a merger involving the first bank would be far less objectionable from the public point of view than would a merger involving the second. Accordingly, a careful inventory of the extent of local and non-local credits in the bank's loan and investment portfolio is called for in order to clarify its role in community financing.

In these ways--through surveys of community views, informed professional judgments, and a review of the record of the bank's participation in financing its community--reasonable bases for judgment can be established as to what the "convenience and needs" of the community are and how well the existing institutions have met them. Against this must be weighed the record and assurances of the merging bank as to what it can and will supply. The final balancing of these considerations remains a matter of judgment but, with evidence before them of the type I have outlined, supervisory authorities can judge with a fair degree of assurance how well a proposed merger meets the "convenience and needs" test. In the 97 approvals noted above, the convenience and need factor was the major or a significant consideration in 53 cases. It was not a significant consideration in any denials. In my judgment, the "convenience and need" factor should ordinarily be accorded more weight than the "banking factors."

The hardest criterion of all to apply, however, is the effect of the proposed merger on competition. At the outset it should be clear that the competitive factor cannot be disassociated from consideration of "convenience and needs," inasmuch as the over-all objective is to provide the banking services desired by the customers on reasonable terms and at fair prices. Indeed, the most conclusive way of assuring that a community's convenience and needs will be met is by the maintenance of so many alternative banking choices that the resulting competition among them will give customers all the opportunity they could wish to move from one bank to another in order to obtain whatever mix of services they desire. But this is rarely a practical criterion. There is a limit to the number of practicable banking alternatives that it is possible to make available to any given community.

In dealing with a change in the status quo there is a popular presumption that any decrease in the number of independent banking units in a given market area will, of itself, decrease competition and increase the tendency toward monopoly. It is my own feeling that this presumption is too harsh a standard to apply without corroborating evidence. Such evidence is to be found in the extent of any unfilled needs of business and household customers in the market areas affected by the proposed merger. And it is to be found in an analysis of the markets involved in the merger--the alternative sources of banking services, the extent of market power exercised by the banks in these markets, and the role in these markets of the particular banks to be merged and the merging bank.

In contrast to the concept adopted in the Philadelphia National Bank case that "the cluster of products and services denoted by the term 'commercial bank' composes a distinct line of commerce" I am of the view that the great variety of unrelated services that banks offer are far more significant than their related services. The corollaries of this view are that banks compete with other businesses fully as much as they do among themselves and that for each service they offer there is ordinarily a different market area and a different competitive situation.

Thus, in order to evaluate the competitive factor, a reasonably accurate delineation of the areas that the merger candidates serve must be developed. From the approximate boundaries of the various service areas for each type of bank activity it is possible to identify the markets that might be affected by the merger, as they are revealed in the overlap of respective service areas.

Among all the services that banks provide, only one of major importance is truly unique and not vulnerable to non-bank competition--the checking account. In all other activities commercial banks face varying degrees of competition from other financial intermediaries or the money and capital markets. As lenders, bank compete with each other and other financial intermediaries or with capital markets in extensions of credit to business (large and small), to consumers, and to governments (Federal, State, and local).

It is quite evident that in many of these markets the merging of any but the very largest banks is unlikely to have significant anti-competitive effects. Non-bank and non-local-bank competition are major factors ensuring competitive performance in the Government securities market, in lending to large businesses, and in the market for most tax-exempt State and local bonds. Nonbank competition is typically vigorous in the consumer credit markets, where hard goods suppliers have their own sources of credit independent of local banks. The same is true of mortgage markets, where other specialized financial intermediaries are dominant. In whatever markets banks face substantial nonbank or non-local-bank competition, it is a fair presumption that the impact on competition of any bank merger will be negligible.

What, then, are the remaining markets in which competitive considerations must be weighed particularly carefully? The most important single market in this category is the market for demand deposit services to local business and individuals. These are services that can be provided only by a bank, and for most such customers only by a local bank. Another important local market is that for savings accounts; in this instance, however, local offices of other financial intermediaries usually offer a similar service. Lately some rate-conscious savers have escaped the orbit of local alternatives altogether and exported their savings from one end of the country to the other.

The small business borrower is another bank customer that may suffer from the removal of an alternative source of bank credit by merger. Even though such borrowers can often obtain trade or supplier credit, the price of such financing may be high and the attendant conditions can be confining. Small businessmen usually find their local banks to be their cheapest, most accessible, and most flexible source of external financing.

In considering the definition of the service area of the bank, then, particular attention should be paid to the potential service areas for small business borrowers and individual and small business depositors--these are the markets most likely to be significantly affected one way or the other by merger.

When chief concern about the possible competitive impact of bank mergers is narrowed down to these two or three market sectors, a great many merger proposals can be said not to raise the competitive issue at all. This is because the banks involved have little or no overlap in their service areas for small business and personal customers. Such is the case when the major objective of the acquiring bank is to extend its activities into another geographical market or into another service field. For example, in Virginia, a State where there has been a great deal of merger activity in the past three years, the preponderance of cases have involved the extension of service areas for banking institutions that are, under a recent State statute, becoming state-wide in their operation. The competitive effect in these cases is not that of the withdrawal of an alternative source of banking service, but typically the substitution of a branch of a larger institution for a community bank.

It is sometimes said or implied that branches of large banks in small communities are unfair competition for local banks. But there are too many instances in which local banks have held their ground in growth and profitability to support a broad generalization along that line. As a practical matter, it may well be that the communities that are most blessed with banking facilities are those that possess a mixture of local banks and branches of larger institutions.

This brings us down to what might be called the hard core of merger proposals--those that turn out, upon examination, to involve two or more banks with overlapping service areas for small business and individual customers. In such circumstances, consummation of the merger undeniably will eliminate one competing bank from the relevant markets. The loss of one alternative for customers in choosing their banking connections in these market areas is almost certain to lead to denial unless the number of actively competing banks is already large, or the bank to be acquired is so small or ineffective a competitor as not to create any appreciable gap in bank alternatives by its disappearance as an independent entity.

Let me turn to the record to give you some indication of how these principles have worked out in practice. The Board's 10 denials in the past 3-1/2 years have, without exception, been based primarily on the judgment that the proposed merger would appreciably lessen competition in one form or another. Bank management factors have significantly weighed for the merger in some of these cases, but in each instance they have been relegated to a secondary consideration.

In the 97 Board approvals of mergers during this same period, the effect on competition was, in the Board's judgment, negligible in 70 cases, favorable in 16, slightly adverse in 23 and in only 4 cases there was significant competition between the merging banks.

You will note that I mentioned 16 cases in which it was judged that the effect of the proposed merger would be to <u>increase</u> competition. The favorable effect that a merger can have on competition, while not common, is, in my opinion, often overlooked by critics of mergers. This favorable effect may arise when the consummated merger puts an end to the monopolistic policy of "home office protection." It usually accompanies the merging of small banks in an area where a dominant competitor holding a very large proportion of the local deposits can only be effectively challenged by a larger institution.

Occasionally merger applications pose a confrontation of an adverse effect on competition, on the one hand, and a favorable effect on serving the community's convenience and needs. For example, the bank proposed to be merged may have exhibited a very limited interest in serving the credit needs of its community--then the only competition lost by merger would be the potential of a new management with a different philosophy. In these circumstances the better alternative may well be a merger.

In an isolated community, to take another example, it is possible that neither of two banks can meet the credit needs of local businesses and farms in the surrounding area but that their combined resources and higher lending limit would enable them to do so. In such cases, the proposed merger might eliminate substantial competition between the merging institutions for some types of banking services but at the same time the resultant bank could do a markedly better job at serving the area's convenience and needs.

My work and experience with the Bank Merger Act in the past 3-1/2 years persuades me that even among the most sophisticated experts in law and economics, the understanding of what it takes to make a competitive market is still quite imperfect. Progress in deepening such understanding comes slowly, and it depends partly upon improvements in analytical techniques designed to define the markets affected by mergers and to appraise the possible impact of mergers upon these markets. I have tried to outline some of the complexities of this task and to indicate my own predilections.

I believe that all concerned with the regulation of bank mergers are sincerely concerned with promotion of the public welfare. It seems to me that the differences in our conclusions rest not on any lack of faith in the efficacy of competition but essentially on differing views as to the relevant markets and evaluation of the impacts of mergers on these markets. The Board is devoting considerable professional resources to solution of these problems in hopes of improving the basis for its judgments. As these efforts progress, I hope they can lay the foundation for a more widespread consensus among all authorities as to where the public interest in bank mergers lies.

Turning now to S.1698, while I share many of Governor Robertson's reservations concerning the immunity it would grant to past mergers, I strongly support the prospective features of the bill. Even though I regard more seriously than many the troublesome problems of divestiture that have arisen, or may arise, in a few cases, I still do not conclude that the situation warrants general immunity from the antitrust laws for all bank mergers that took place before the enactment of this bill.

Clearly these difficult situations should be avoided in the future. Fortunately, cases in which a bank supervisory agency approved a merger but the Attorney General brought suit to prevent it have been infrequent. In fact, none of the 97 mergers approved by the Board in the past 3-1/2 years has been contested under the antitrust laws and I understand the Attorney General has said he has no intention of doing so. Nevertheless, the difficulties of undoing a merger are great enough that I believe a procedure should be established by statute to prevent such cases from arising.

One of my reasons for being concerned about the problems of divestiture is that I see no practical device for spinning off depositors in non-branching states. A bank can spin off assets in the form of securities and loans without difficulty; it is the very essence of banking that it be in a position to do so. A bank can, neglecting the human problems of its staff and officials, spin off personnel and operating know-how. A bank can, with considerable disruption to customer relationships and convenience, sell or spin off branches and with them the propensity of local residents and business to patronize that branch. But how can a unit bank sell or spin off its depositors, assigning them to a new bank or existing institution? And how can it organize a new institution without owning it or controlling it indirectly? While spinning off assets, operating personnel and branches involves difficulties and hardships, spinning off depositors in a non-branching state may defy solution. S.1698 offers an effective preventive remedy for this problem.