I. *A Statement of Policy*

THE NATION'S INDUSTRY and commerce are alive with change. If the banking industry is to serve their needs most effectively, it will have to match the initiative and imagination displayed elsewhere in the economy. The temper of the banking industry, and the energy with which new opportunities are created and pursued, will be critically affected by the attitudes of the public authorities. A negative or unreceptive outlook on the part of the regulator may dampen the initiative of banks and impede effective response to public demand for banking services and facilities.

For nearly four years, we have been engaged in an effort to broaden the opportunity for private initiative in the National Banking System, insofar as this could properly be done in the light of existing law and the public purpose to sustain and safeguard the viability of the banking system. In our 101st Annual Report to the Congress, we reviewed the changes that were instituted and those advocated with respect to the operating powers of National Banks. In this 102nd Annual Report, we shall examine the changes of policy and practice relating to the structure of the National Banking System.

The banking structure that is most ideal in terms of the public need will vary with the changing requirements for banking services and facilities. Like the operating powers of commercial banks, the structure of the banking industry must continuously be adapted to emerging demands and opportunities.

All of the forces of change which are at work throughout the economy, both domestic and international, influence the ideal banking structure to be sought. In our prosperous and vigorous society these changes are constant, far-reaching, and of compelling importance. Increases in personal income and population affect the volume of savings seeking productive uses. The growth of capital and advances in technology bring new products and new industries. These, in turn, often give rise to new communities and shifts of population. Population movements are further accelerated as income levels rise and permit the purchase of new homes. All of these factors have worked to produce demands for additional types of banking services and for banking facilities at new locations. The responses by the banks and the banking authorities to these new demands and opportunities have molded the evolution of the banking structure.

"Structure" is a term generally used to describe the composition and dispersion of an industry, geographically, by size of unit, and by the range of products manufactured and distributed. The structure of an industry is also affected by the ease with which new firms may enter and existing firms may expand. In all industries, structure is influenced by such factors as the location of the materials of production, the accessibility of markets, and production and demand conditions, as well as by unique factors such as the inventive process and enterpreneurial initiative. Banking, however, and the other regulated industries, differ fundamentally from the unregulated industries in one significant respect—the influence of government on structure.

In the unregulated industries, the influence of government on structure is at a minimum. In these industries, the broadest scope is preserved for individual initiative; public controls are, for the most part, either indirect or peripheral. Except in unusual times such as war, it is rare in the unregulated industries to impose precise and positive rules of conduct for the individual. He is forbidden to engage in certain practices and certain governmental activities may indirectly affect the choices he makes, but beyond these limiting factors he has a free choice of entry and free discretion to select his own investment, production, and marketing policies. For example, although the total supply of money and credit is regulated, the government does not normally allocate their uses nor fix the prices of goods and services produced and sold. Collective bargaining is required, but wage rates are not fixed. Anticompetitive accretions of market power and deceptive practices are controlled, but there is no effort through public authority to select and enforce any exact set of competitive conditions.

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This is in clear contrast to the public policies followed in the regulated industry of banking. In virtually every significant aspect, the structure of the banking industry is directly controlled by government. Entry into banking is restricted and the expansion of existing banks is closely regulated. No bank may be formed without a charter from the government. No bank may expand its size through the acquisition of new capital or the formation of new branches without the sanction of a public authority. No bank may expand through the acquisition of other banks without the prior approval of government.

Underlying this intercession of government in banking is a basic public policy that sets this industry clearly apart from others. The factor which distinguishes banking from other industries is the public concern to safeguard the viability of the banking system. This concern is founded upon the central role which banking performs in the economy, and the critical significance of public confidence in the banking system. The banking system provides the chief instrument of payment in the conduct of business and private transactions, and it represents one of the principal channels through which savings are directed to productive uses. In order that these functions may be performed effectively, there must be public confidence in the banking system. Without such confidence, funds would not be deposited in banks nor would checks be accepted in payment of transactions, and the performance of the entire economy would be greatly impaired.

There are three basic forms of public control that affect the structure of the banking industry: (1) chartering controls; (2) branching controls; and (3) merger controls.

A. *Chartering Controls*

The imposition of entry controls through the requirement of a public charter represents the most fundamental structural regulation of the banking industry. In the unregulated industries, freedom of entry is preserved as the essential basis for the reliance placed on private initiative to exploit profitable opportunities for serving consumer demands, and generally to make certain that productive resources move to their best uses throughout the economy. It is recognized that free entry may result in the elimination of inefficient competitors, but this is regarded as a small price to pay for the public benefits of private initiative and innovation. Failures in banking, however, are considered to be of greater public consequence than failures in other industries because of the broad effects on confidence in the banking system and the severe incidence on individuals and small business firms. Entry restrictions have thus been adopted as one of the measures for preserving the viability of the banking system.

Since the existence of entry restrictions deprives the public of the full benefits of competition in meeting consumer demands, it becomes the responsibility of the regulatory authorities to make certain that entry controls are not so severely administered as to inhibit the provision of needed banking services and facilities. If the public authorities are insufficiently alert or sluggishly responsive to emerging requirements, artificial shortages may appear. This is precisely the situation which prevailed several years ago as a result of postwar changes in the size and location of population and industry.

Shortages of supply normally create mounting pressures for market entry in a capital-rich and dynamic economy such as our own. This poses administrative problems where there is public control of entry. As the saturation point is approached in a market under the pressure of new entry, it becomes increasingly difficult to make accurate estimates of need and potential profitability. Moreover, in order to sustain the viability of the banking system, it is desirable to preserve opportunities for new banks to grow to efficient size. For these reasons, a temporary halt may occasionally be required in the chartering of new banks in some markets, as occurred under the more responsive chartering policies of the past several years.

Some observers have been concerned lest the chartering of new banks should proceed so far as to increase the rate of bank failures, and it is worthwhile to consider how firm the safeguards against failure should be in the chartering of new banks. It must be remembered that bank entry is regulated not because there is a private right of existing banks to be protected against competition, but because there is a public concern to sustain the viability of the banking system. It can never be in the public interest to protect banks against competitors who are either more efficient or more responsive to public demands. There are, moreover, positive public benefits to be derived through the periodic introduction into the banking industry of new competitive forces with fresh ideas and fresh talents.

An absolute safeguard against bank failures resulting from new entry would require an absolute bar against entry, for any new competitor will have some effect on his rivals and will himself run the risk of failure. In order to reconcile the need to protect the viability of the banking system with the equally vital need to assure sufficient production of banking services, a unique combination of public policies has been adopted. Applications for entry are carefully screened in terms of public demand, potential profitability, and effects upon competitors. In order to assure the capability of new banks to operate efficiently and effectively, certain minimum capital requirements are imposed, and the competence of proposed management is appraised and approved by the regulatory authorities. The operating policies and practices of all banks are continuously supervised to sustain their solvency and liquidity. Finally, as an ultimate safeguard where failure does occur, a system of deposit insurance has been provided. Through these measures, confidence in the banking system is preserved without paralyzing the competitive forces. Thus, the banking industry is enabled to undertake the risks that are required in serving the demands of a thriving and flourishing economy.

The chartering of new banks represents, in many respects, the most delicate task which confronts the bank regulatory authorities. A new bank represents a new competitor, and a new competitor is rarely welcome in any industry. On the other hand, since bank charters are valuable because they are limited in supply, they are actively sought by competing applicants. The public authorities are thus subjected to intensive pressures both from those who seek charters and those who oppose them. Moreover, in reaching decisions on charter applications, there can be no absolute certainty of the fate that will befall new banks or their competitors.

Despite these difficulties of administering entry controls, banking must not be treated as a "closed" industry. Each new generation produces a new group of men and women of skill and ability seeking outlets for the use of their talents, and in our prosperous society there is a constant accumulation of capital in search of profitable employment. In some measure, these new productive resources will find their best uses in the banking industry, and the public will benefit by allowing them access to that industry.

B. *Branching Controls*

The second principal form of structure control is the regulation of branching. A bank may expand internally through the formation of *de novo* branches, or externally through the absorption of other banks by means of merger. Merger controls, however, raise a number of separate issues and will be discussed in the next section.

The policy issues confronted in branching are in many respects similar to those which appear in the chartering of new banks. Since the formation of a *de novo* branch introduces a new competitor into a market, the same questions arise of public need or convenience, potential profitability, and effects upon competitors. But inasmuch as branching increases the size of an individual bank, new issues also emerge concerning the potential for greater operating efficiency and for enlargement of the range of services offered to consumers.

There will be some circumstances in which a new branch will be able to serve public demand to better advantage than a new bank. Some banking markets can profitably support a new branch where a new bank could not prosper. A new branch may be able to bring to a community a broader range of services than could be efficiently provided by a newly chartered bank. Moreover, the abandonment of a branch will be less harmful—both to the parent bank and to the banking system—than the failure of a new bank; thus, where prospects are not immediately certain, or where expansion is based partially on anticipated growth in demand, branching might be the preferred course. The choice of whether to provide for bank expansion through new charters or through new branches is also affected by other considerations which are discussed in the next two sections.

Much of the recent demand for new branches, as has been true of that for new charters, stems from the growth and shifts of population and the creation and relocation of industries. Very commonly in recent years, for example, the movement of population from urban to suburban areas has deprived urban banks of customers and created new demands in suburban areas. Moreover, the growth of new industries often gives rise to new working and residential communities with new needs for banking services and facilities. Through branching, a bank may "move with its customers" and retain its position in the industry. The broader the geographic dispersion of a bank's offices, the more readily may the deposits from surplus areas be put to effective use in areas where loan demand exceeds the deposits generated. Further, by increasing its size, branching may enable a bank to produce some services at lower cost. It may also enable a bank to spread its risks more effectively and thus allow engagement in lending activities that would not be feasible for a smaller bank. A larger bank, moreover, has a larger legal lending limit and so may serve certain classes of customers more effectively than smaller banks.

In the unregulated industries, the economies of scale actually realized, and the variety of services actually performed, are determined competitively. In banking, however, the regulatory authorities have the ultimate responsibility to choose the means of bank expansion best calculated to serve the public interest. Their decisions will inevitably affect the prices and range of products and services offered to consumers.

The authority to permit the formation of branches is much more severely restricted than the power of the regulatory authorities to allow the creation of new banks. These long-standing traditions with respect to branch banking have had a deep-seated and far-ranging effect upon the entire banking structure of the country, and upon the performance of the banking system. They have greatly enlarged the number of banks, hampered the growth of banks to most efficient size, inhibited the development of specialized services by many banks, and diminished the effectiveness and efficiency of the banking system in the vital task of facilitating the movement of capital to its best uses throughout the Nation. In some degree, these limitations have been overcome through the solicitation of loans and deposits in areas beyond the powers to branch, and through the establishment of affiliates, satellites, or holding companies. These, however, represent generally inferior means for the expansion of banking operations.

There is the mistaken belief that broader authority to permit branching would lead to harmful effects upon competition in the banking industry. Greater power to allow the formation of branches, however, would merely add to the discretionary authority of the regulatory agencies. Equipped with a more extensive range of alternatives, the banking authorities would be in a better position to choose the precise means of bank expansion most suitable to serve the needs of individual banking markets, and most likely to provide the required services and facilities at the least cost. Indeed, the risk of monopoly power is greatest where the greatest reliance is placed on unit banking. Since new branches might be able to operate profitably in markets where new unit banks could not survive, the prohibition of branching would exclude potential competitive forces from these markets.

There is no consideration of the public interest which would justify an absolute withholding of the branching tool from the regulatory authorities. The only proper basis for the restriction of branching is the suitability of this means of bank expansion to serve emerging public demands in particular banking markets. Under this principle, the regulatory authorities should have the full discretion to authorize the formation of branches wherever they can serve the public interest to best advantage.

C. *Merger Controls*

The third means by which government influences the banking structure is through direct administrative control of mergers. In the unregulated industries mergers may be freely undertaken, subject only to prosecution under the antitrust laws. In banking, however, mergers require the prior administrative approval of a regulatory authority, and the regulatory agencies in reaching their decisions apply a variety of statutory criteria relating to the banking and public consequences of proposed mergers.

The desire to merge is critically affected by the power to branch. Merger applications rarely appear in no-branch States because a merger under those conditions usually requires the closing of one of the merged banks. Thus, two tools of structure control are effectively lost where branching is prohibited, and needed bank expansion must take place almost entirely through new charters.

The public benefits which may be derived from mergers stem basically from the economies of large-scale enterprise, and the greater variety of services which larger firms may offer to consumers. These benefits will arise where increases in the scale of operations yield savings in costs, or where a broadening in the lines of production or the extension of operations to new markets permit greater dispersion of risks and thus allow the undertaking of ventures unsuitable for smaller firms. A larger and more broadly based bank may also be able to offer specialized services which are not profitable for smaller institutions, and should be able to move capital more efficiently from surplus to deficit areas. Moreover, the legal lending limits of banks require the presence of larger institutions to meet the needs of larger businesses most proficiently.

In our public policy for the unregulated industries, we have generally distinguished between the growth of firms through internal expansion and their growth through merger. Growth through merger has been viewed with greater public concern because it entails the elimination of competitors and, for this reason, merger limitations have been imposed through the antitrust laws. The direct administrative controls applied to bank mergers are also based in part upon the competitive effects of such mergers, but, as we shall see, the banking authorities apply a variety of other public interest criteria in deciding bank merger cases. These criteria are specifically related to the fact that the banking structure is under direct public control.

There is some probability that growth through merger may have a more adverse effect on the liveliness of competition than growth through internal expansion. However, there are countervailing considerations. A merger may enable a firm to acquire plant, personnel, and market-access not otherwise readily attainable, or attainable only at greater cost. More fundamentally, even though the intensity of competition may be adversely affected by growth through merger, merger may nevertheless produce benefits of larger-scale production which are in some degree passed on to consumers in the form of improved service or lower prices. The task of public policy is to allow those increases in the size of firms that are, on the whole, beneficial to consumers, while restricting those that are, on balance, harmful.

There are two reasons why merger may often be the preferred course of expansion in banking, even though in comparable circumstances reliance on internal growth may be more appropriate for the unregulated industries.

First, the banking authorities have a positive responsibility to see that the public convenience and need for banking services and facilities are met. In carrying out this responsibility, they do not have the authority to require the provision of service such as is found in the fully regulated industries like the "public utilities"; their choices are limited to the private proposals for bank expansion presented for their approval. If they find that a proposed merger will yield public benefits and they see no superior means for achieving these benefits either at hand or in clear prospect, they have a strong positive reason for approving the merger. In the unregulated industries, there is no public responsibility to fashion industry expansion according to the public need; reliance is placed on private initiative and no public authority faces the problem of choosing the form or method of industry growth.

Second, in choosing the *best* means to serve the public convenience and need for banking services, the banking authorities must appraise the alternatives in terms of the effects on the solvency and liquidity of competing banks. Bank merger proposals are generally designed to provide new services to a community, to provide services at lower cost, or to enter new markets. The alternative means of achieving these purposes are new charters and *de novo* branching. If the existing banks in a market are poorly managed, financially weak, or unprogressive, such added competition may threaten their solvency or liquidity and merger may constitute the only effective means of bringing improved service to a community without posing a threat to bank viability.

In the unregulated industries, there is no public concern to safeguard individual firms against failure. Indeed, in these industries freedom to compete and to eliminate less efficient rivals is essential to the reliance placed on private initiative to serve consumer demands. It is therefore appropriate in the freely competitive industries to impose more severe restrictions on growth through merger than are applied to banking.

Bank mergers have sometimes been opposed on the ground that, although they may improve service for some classes of consumers, they may do so at the expense of others. Some classes of consumers, however, have needs which only larger banks can serve efficiently. If other classes of consumers are disadvantaged by a merger, a new opportunity is presented to competing banks and the banking authorities may respond by authorizing new charters or new branches. In this way, the needs of *all* classes of bank customers may be served most efficiently and most effectively.

The Bank Merger Act of 1960 provided for direct administrative control of bank mergers by the banking authorities, and established broad public interest standards to guide the administration of these controls. In addition to the "effect of the transaction on competition (including any tendency toward monopoly)," the banking agencies are required to consider the financial history and condition of each of the banks involved, the adequacy of their capital structures, their future earnings prospects, the general character of their management and, most significantly, "the convenience and needs of the community to be served." Mergers are to be approved only where, after considering all of these factors, the transaction is found to be "in the public interest." Since the passage of the Bank Merger Act, however, two Supreme Court decisions have subjected bank mergers to the antitrust laws. This has given rise to ambiguities of policy and conflicts of purpose.

The problems are both philosophic and procedural. There is no serious dispute about the desirability of applying antitrust principles to the unregulated industries. Since in those industries primary reliance is placed on individual initiative and private enterprise to meet consumer demands, there are justifiable reasons for preserving freedom of entry and restricting the acquisition of market power in order to enable the competitive forces to function. In banking, however, entry and expansion are under direct public control. The competitive forces are purposefully restricted in order to safeguard the viability of the banking system, and an effort to apply conventional antitrust principles in these circumstances is almost certain to conflict with bank regulatory objectives.

This is well demonstrated by the difficulties that have been encountered under the Bank Merger Act since the *Philadelphia* and *Lexington* decisions brought bank mergers under the antitrust laws. Although the banking agencies must continue to reach their decisions according to the broader public interest standards set forth in the Bank Merger Act, their decisions are now subject to attack in the courts under the narrower standards of the antitrust laws.

This impasse can be clearly resolved only be exempting bank mergers from the antitrust laws completely as has been done in other regulated industries, or by subjecting such mergers to the full application of those laws. If this latter course is chosen, the Bank Merger Act should be repealed. There would seem to be no valid reason for subjecting banks to more onerous premerger requirements than apply in the unregulated industries if bank mergers are to be subject to attack under the antitrust laws. More fundamentally, if it is to be public policy to apply conventional antitrust concepts to banking, it logically follows that bank entry and bank branching should also be free of direct public control. The least satisfactory course is the present one of entrusting regulatory powers to the banking agencies and judging the exercise of those powers on the assumption that the competitive forces are to be fully preserved and fully operative. It should be observed, however, that a decision to move toward free bank entry and expansion raises questions which go beyond the problems of banking structure. It is highly doubtful that bank operating practices could be effectively supervised, and the viability of the banking system sustained, without some form of public control over the banking structure.

There is one intermediate course through which a reconciliation might be achieved between the Bank Merger Act and the antitrust laws without a statutory change. The courts, in antitrust cases involving bank mergers, could take cognizance of the fact that banking competition is restricted through public regulation, and that bank mergers receive prior adminstrative approval from a public authority according to broad public interest standards which transcend purely competitive considerations. This approach would not be as clear-cut as the other alternatives we have presented, and would undoubtedly leave large areas of uncertainty for long periods. Nevertheless, if in bank merger cases the courts considered the unique competitive conditions which prevail in the regulated industry of banking, there would be a greater likelihood that the antitrust criteria developed principally with the unregulated industries in mind could be adapted to banking without impairing the effectiveness of bank regulation. An effort to test this approach for accommodating these two basic strands of our public policy was recently undertaken by the Comptroller of the Currency as an intervening defendant in an antitrust action relating to the merger of the Mercantile Trust Company N.A. and the Security Trust Company, both of St. Louis.

There is one administrative procedure under the Bank Merger Act which should be modified if that Act is to remain in force. At present, the banking agencies not directly involved in a merger decision are required to submit advisory opinions on the "competitive factor" to the responsible agency. Since this factor comprises only one of the seven considerations required to be taken into account, the advisory opinions do not represent a judgment on the desirability of a merger. Nevertheless, differences between the advisory opinions and the decisions on mergers have often been falsely cited as evidence of differences in merger policy among the banking agencies. Moreover, five years of experience under the Bank Merger Act have demonstrated that the advisory opinions of the banking agencies not faced with the responsibility of decision are ordinarily routine and rarely present facts or ideas unknown to the responsible agency. There seems to be no proper reason for continuing this procedure.

Retention of the Justice Department advisory opinions may appear to have greater justification. However, the role of the Justice Department in bank merger cases will ultimately rest on the resolution of the more fundamental issue of the proper applicability of the antitrust laws to the regulated industry of banking.