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"The need to be able to delineate banking markets within which supervisory decisions are relevant is becoming increasingly pressing," declared Chairman K. A. Randall of the Federal Deposit Insurance Corporation in a speech before the final session of the annual convention of the National Association of Supervisors of State Banks in Honolulu. Because banks are playing a much more active and important role in financing than at any time since the Great Depression, definition of banking markets is most topical, said Chairman Randall in his speech entitled Banking Markets: A Supervisory Viewpoint. The Bank Merger Acts of 1960 and 1966, moreover, have indirectly reemphasized the necessity for the Federal bank supervisory agencies to know more about the market for banking services.

"Most mergers in recent years present minimal anticompetitive implications for the market from a regulatory standpoint," Mr. Randall pointed out. "But it is the borderline cases -- where the merging banks are in competition with each other as well as with other banks" that present the bank supervisors with the thorny problems. "The assessment of competition must necessarily relate to a particular area -- whether geographic or functional in scope ... But economically and statistically meaningful measures of markets are not easily developed, although the availability of today's more sophisticated analytical techniques and better data are of great assistance."

Chairman Randall went on to discuss a number of problems involved in defining banking markets from both a conceptual and practical standpoint. The FDIC itself has been working on the development of some techniques to

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help in determining market boundaries. The ability to delineate banking markets also helps in identifying the package of "convenience and needs" that customers demand of their banking connection.

Even when the relevant banking market has been identified, we "find ourselves face to face with an even more fundamental problem," Chairman Randall declared -- that of the appropriate banking structure for each state and for the country as a whole because supervisory actions involving banking market concepts obviously have a direct bearing on the overall structure of banking. "To some extent, many of our supervisory actions in the past have tended to neglect the long-run implications for the banking structure." Mr. Randall stressed that this situation could not be permitted to continue. "The pace of economic and social change is accelerating, the kinds of bank services are in the process of changing, and competition with nonbank financial institutions is intensifying ... It is therefore imperative that bank supervisors -- at both the State and the Federal levels -- encourage a reassessment of the present structure and the banking system's capabilities currently and for the future."

Chairman Randall then asked his audience to consider the kind of banking system needed for the future. He indicated that decisions about the future shape and direction of the banking system would necessarily be influenced by each individual's own philosophical predilections as well as ideas concerning the shape of the future market for credit and the supply of credit, the role of the new technology, and the future of nonbank financial intermediaries. Chairman Randall noted that the traditional answers might no longer be appropriate. In working toward new answers, he emphazied that the primary responsibility of banks and the supervisory authorities continued to be the provision of banking services to the public.

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BANKING MARKETS: A SUPERVISORY VIEWPOINT

Analysis of banking markets is an important and valuable tool in the consideration of major issues confronting banks and bank supervisory authorities. The need to understand and analyze banking markets has grown because of recent developments. Banks have become much more active centers of financing than at any time since the Great Depression and must be counted among the major business entities of today. Furthermore, additional data regarding the behavior and performance of banks have become available, together with improved analytical techniques and new technologies. So, for these reasons, it should be helpful to discuss banking markets, especially with a group of bank supervisors.

Perhaps the best way to lead into this discussion of banking markets is to suggest in outline at least its importance in the area of bank mergers.

Ever since the Federal bank regulatory agencies were specifically given the authority to approve bank mergers and consolidations by the Bank Merger Act of 1960, increasing attention has been focused on banking markets and other factors that must be considered in these applications by the banking agencies involved -- whether in an advisory capacity or as the agency with primary responsibility for approval or disapproval. The Bank Merger Act of 1966 has introduced some additional dimensions and interpretations. Banking market analysis is therefore not likely to diminish in importance.

Most mergers in recent years present minimal anticompetitive implications when their impact on the market situation is evaluated. If both or even just one of the banks involved in a merger are small, both relatively and in an absolute sense, there may be no significant diminution of competition. The distance between the two institutions may be so great as to preclude any overlap of customers and service areas. Or their types of operation and services offered may be sufficiently different so that each bank in effect serves disparate groups within the same geographical area. To be sure, the merger brings a change of ownership, but in these instances the number of actual banking alternatives is unchanged in the market area of the bank being absorbed. What has happened is that one banking institution has replaced another, although other factors such as potential competition and the relative competitive behavior of the two banks may also be issues. In addition, there are mergers of banks, which separately are too small to compete effectively in a larger market because of restricted lending limits, lack of specialized personnel, or similar constraints. Under these circumstances, the resultant bank is brought within the range of choice of more customers and the availability of banking services in that market is increased.

A third type of market situation in merger cases involves a bank -- generally the one being absorbed -- whose management policies do not result in effective competition with <u>any</u> other bank in any market. Under these circumstances, merging again will bring little diminution in existing competition.

In a sense, the floundering or failing bank belongs in this third category. Where the situation is clearly serious, the banking agencies encounter little or no opposition in approving a merger which salvages a failing bank and results in a more vigorously competing institution furnishing better service to the community. The thorny question here is determination of the point at which a bank is no longer viable.

Beyond the obvious cases, however, are the borderline cases -- where the merging banks are in competition with each other as well as with other banks. The bank supervisory authority is then obliged to utilize whatever relevant information is available, including specialized analyses of market areas, in order to assess the competitive impact of the proposed merger.

This assessment of competition must necessarily relate to a particular area -- whether geographic or functional in scope. The relevant concept for consideration of competition -- as well as convenience and needs -- seems to me to be the market for banking services, however defined. But economically and statistically meaningful measures of markets are not easily developed, although the task has been made somewhat easier with the availability of today's more sophisticated analytical techniques and better data. Such data include information on markets and submarkets for various bank products and services -- their prices, terms, and availability.

The physical limits of banking markets vary of course with the size and type of customer and with the type of banking service offered. In the case of demand deposits, for instance, the provision of checking account facilities is to a great extent a unique function of commercial banks and one that is furthest removed from nonbank and nonlocal competition. But even this uniqueness is being eroded by somewhat comparable services being offered by some nonbank financial intermediaries at the present time. And some nonlocal banks also compete effectively for demand accounts, particularly these of large size, and for large time deposits, especially the increasingly familiar negotiable certificates of deposit. Thus, distinctions that once seemed clearly drawn are becoming blurred. As a consequence, the need to be able to delineate banking markets within which supervisory decisions are relevant is becoming increasingly pressing.

From a public policy standpoint, the banking agencies have to be concerned with the impact of their decisions on the local market. It is in the local community or market where elimination of competition or failure to meet convenience and needs can have the most damaging effects. Individuals and small businesses with deposit accounts and credit demands modest in size are those with the most limited banking alternatives, even if they are judged to be creditworthy. In the absence of local credit accommodations and deposit facilities, their range of choice may be severely limited or nonexistent.

In an attempt to describe a local banking market, for example, it would be possible to begin by taking small demand accounts of individuals and businesses as a yardstick. The yardstick is not absolute and certainly not exclusive -- but it serves as a reasonable starting point because demand accounts are still more or less unique to commercial banks. These same demand account holders, moreover, generally require financial services obtainable again only within the same banking market. As data are developed, the yardstick can be expanded to include other measures of local markets.

Here at the Corporation we have recognized for some time the need to define more clearly and precisely what is meant by a banking market. One result has been the development of sequential sampling techniques which may help to determine within a prescribed tolerance the number of various types of depositors of a bank in any given area. Application of these techniques will enable us to estimate the extent to which, for instance, two or more banks proposing to merge have penetrated into one another's service area. The same technique could be used to determine the presence and extent of activity of other banks in this market. As a result, a quantitative measure of the number of small (and therefore "local") demand deposit holders whose banking alternatives would be affected by supervisory action -- and the extent to which they might be affected -- will be available.

But even this is not sufficient. It is only the initial step. Not only must we be able to obtain a fairly good idea of the boundaries of the banking market but we must be able in the near future to identify and define the package of convenience and accommodation that bank customers demand of their banking connection.

The Corporation already has available -- as do the other supervisory agencies -- some data on customer banking needs and on the adequacy of existing bank services compiled from the applications filed with us, our own field investigations and examinations, and information supplied from other sources. This information is being studied to extend the boundaries of our knowledge. On the assumption that our data base -- supplemented by more sophisticated techniques and advanced technology -- can help the supervisory authorities to identify the relevant banking market, we then find ourselves face to face with an even more fundamental problem. Given the banking market -- with its depositors and borrowers, its services and its needs, what criteria should be considered by the supervisory authorities in their decisions affecting the particular market in question?

Although the bank supervisory authorities in the States are not immediately concerned with administration of the Federal banking statutes, our actions on bank applications obviously have a direct bearing on the overall structure of banking. And your decisions on applications by banks, although governed by different statutory provisions, establish the basic framework within which our decisions in turn must rest. Consequently, it is essential that both the State and the Federal banking authorities face squarely the question of the kind of banking structure we want and the means whereby it is to be achieved.

To some extent, many of our supervisory actions in the past have tended to neglect the long-run implications for the banking structure. The results of our actions therefore can be less than ideal because our goals are poorly defined. Our task is further complicated by the existing banking structure which in some areas of the United States has made it difficult for the banking agencies to ensure that the public receives the best banking services.

When the pace of economic and social change was slower and the need for banking facilities was under little pressure, the lack of a clear-cut concept of the appropriate banking structure did not constitute a major handicap. But this situation no longer holds true. The pace of change is accelerating, the kinds of bank services are in the process of changing, and competition with nonbank financial insitutions is intensifying.

Banking may find that it can no longer serve the community and the economy efficiently and effectively within its present framework and constraints. It may be necessary to modify the framework and relax some of the constraints -- or even initiate more radical changes. The first requirement is to decide in which direction we want to progress. It is imperative that bank supervisors -- at both the State and the Federal levels -- encourage a reassessment of the present structure and the banking system's capabilities currently and for the future.

Our actions and our decision -- even more than before -- must be oriented toward the realities of the dynamic economy in which we live. Our decisions must contribute to a better and stronger banking structure -- not merely reinforce the status quo or, even worse, discourage progress, adaptability, and innovation. We must be prepared to help shape the future direction and scope of the banking system -- and not permit it to drift aimlessly.

Because our banking system -- unlike that of many other countries -- consists of numerous independent units and is subject to dual regulation at the State and Federal levels, it is especially important to know where we are going -- or should be going.

Let me pose therefore a few of the hard questions that require our best thinking and our best answers. We first must consider the kind of banking system needed for the future -- in terms of the number of institutions, their size, their geographical location, and similar structural characteristics. The present banking structure may not in all cases be the type of structure best suited to the financial requirements of the economy in the future. At the same time, these decisions will necessarily be influenced by our own philosophical predilections as to appropriate market shares, the desirable degree of concentration, and the benefits of relatively unencumbered competition. In addition, supervisory decisions that have an initial impact on banking markets and more basically on banking structure must be founded on fairly concise ideas concerning the types of demands to which banks may be subject in the future, the types of services they can or should offer, and their potential capabilities. With the advent of automation and third-generation computers, the question arises as to the appropriate role of this development in the banking picture of the future and their impact on bank operations and services.

Closely related -- but not always considered in the same context -- is the role of nonbank financial intermediaries and near banks. Should nonbank financial institutions, for example, be encouraged to perform some or all of the traditional banking activities or should they be encouraged instead to become banks?

These are just some of the fundamental questions that we should be asking and trying to answer. The traditional answers may no longer be appropriate. The Bank Merger Acts of 1960 and 1966 also deserve some credit in indirectly compelling us to face the vital issue of the type of banking structure needed to fulfill satisfactorily the financial requirements of the future.

If has been relatively easy to pose the questions; it will be much harder to answer them. But once the problem is at least identified, we have made a start. In this task, our primary responsibility continues to be our responsibility to provide the public with the banking services that it should have -- and this is the final test that we must meet.

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