Statement of
George W. Mitchell
Member, Board of Governors of the Federal Reserve System,
before the
Subcommittee on Bank Supervision and Insurance
of the
House Committee on Banking and Currency
on H. R. 5874

May 8, 1963

My remarks today will be addressed not to the details of H. R. 5874 but to two underlying problems in the area of bank supervision. These problems, relating to bank charters, branches, and mergers, on the one hand, and to bank examination, on the other, have a bearing on the organization of bank supervisory functions in the Federal Government.

I should like to make it clear that I am not appearing here today in opposition to the proposals of my colleague, Governor Robertson, that much would be gained by unifying the three arms of Federal bank supervision.

The essence of my position, however, is, first, that unification would still leave unsolved the problem of bank mergers and entry, and, second, a case can be made for unifying bank supervision in the Federal Reserve rather than in a new independent commission.

Bank Structure and Competition

Governmental regulation of the banking business, by control over chartering, branching, and merging, is divided among three agencies--each of which has responsibility for decisions involving a segment of the banking industry. This arrangement is a possible but not necessary source of inconsistent practices. Under the broad

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

guidelines laid down in the Merger Act, for example, it is conceivable that the agencies and individuals involved could accord differing weights to the statutory factors to be considered. In particular, different views of effects on competition could give rise to a pattern of inconsistent decisions among the three agencies.

This is possible. In fact, however, I believe there is nearly as much likelihood of inconsistency between decisions of a single agency as there is between those of different supervisory agencies. The reason for this is not hard to find. The seven factors which an agency must consider before determining that a merger would be in the public interest are often exceedingly difficult to judge and to weigh one against the other. In particular, reasonable and conscientious men may and do differ deeply on the interpretation and weighting of the competitive as against the banking criteria and convenience needs of the community specified in the Merger Act. There are, in consequence, many borderline cases which may easily fall one way or the other in terms of approval or denial. In such circumstances, it is not clear that a single agency would provide a more uniform pattern of decisions than do three agencies now.

These considerations do not argue against the bill before you. They do, however, indicate that the proposal is far from a panacea for the solution of difficult problems.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

As I see it, the consistency problem in the merger area, as of now, has its source more in the absence of clear guidelines than in the existence of divided authority. What is needed is a considerable effort at fact gathering and analysis, as well as a re-thinking of goals, with a view to developing a clearer set of criteria to guide decisions in individual cases.

There is much to be done in the way of fact gathering and analysis of banking markets and price behavior in those markets. For some reason this area has been much neglected in both academic and governmental studies of business organization and behavior. Just recently, the Federal Reserve has taken steps to expand its reseach on the subject of the market performance and market structure of commercial banking.

It is also necessary to re-think the goals of policy in governmental regulation of bank structure. It seems to me that we would be performing rather badly in our task of regulation if our thinking were dominated by uncritically-accepted guidelines appropriate to conditions long since gone. We need to recognize, for example, that in many parts of the country the structure of independent unit banks has given way to large branch and holding company systems. In each of twenty States one-half of the bank deposits are accounted for by fewer than four banks, counting for this purpose holding companies as a single bank. I am attaching to this statement a brief appendix showing banking concentration ratios for each of these States.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

With the trend to larger banking units, we need to reappraise the notion of a fundamental conflict between safety and competition in banking. Conditions have changed greatly since the pre-Civil War wildcat banking and, indeed, since the bank failures of the 1930's. I am certainly in favor of bank soundness, but I also believe that severe restrictions on bank entry and merger decisions that emphasize safety at the expense of competition do not serve the public interest; they may be only a step away from providing monopolistic sanctuaries.

The re-thinking that should, in my opinion, occur here is to ask ourselves just how serious the conflict between safety and competition is. Are banks in our present economic environment really in danger when other banks enter their market areas to compete? Are depositors really endangered by "too much" competition?

It is my conviction that policy is and should be shifting from an excessive concern with safety to a more pro-competitive approach. Freer entry should be permitted. Finally, branches that promote competition in areas that are now sheltered from it should be authorized.

These, it seems to me, are the major problems in the area of bank structure. What I wish to emphasize is that unifying bank supervision will not by itself solve these difficult problems. Once a clearer and more reliable set of standards is developed to guide decisions on individual applications, a single agency might well be in a position to apply them more consistently than would several agencies. Similarly, a single agency might be more successful than

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

three agencies in helping to develop a clearer and more up-to-date set of goals. I am not opposing the objectives of the bill before you. What I am suggesting is that changing the organization of bank supervision does not change the nature of the job to be done.

Bank Examination

I should like to introduce my comments on the subject of bank examination with a quotation from a speech by Chairman Cocke of the Federal Deposit Insurance Corporation:

> "Recent developments in banking call for both new approaches and new methods in regard to the examination problem. For example, the size of banks and the complexity of their operations have increased tremendously over the past three decades. These changes in size and complexity impose a special obligation on the supervisory authorities to be vigilant for practices that may affect adversely the effectiveness of the traditional examination. The precise nature of the limitations on the value of the usual examination, and the consequences for bank supervision, are unknown. However, it seems doubtful that examination techniques designed for a banking system comprising many small units with few opportunities for specialization of work assignments are entirely suitable for giant banking organizations which can make effective use of highly skilled technicians. This is one of the many aspects of bank examination work that deserves further serious consideration." 1/

I believe that a reappraisal along the lines suggested by Chairman Cocke could result in a streamlining of examination procedures. For one thing, in the case of large banks, including branch and holding company systems, there is little if any need for accounting verification

1/ "Bank Supervision and Examination at the Federal Level: Issues and Policy Problems," at the Annual Convention of the National Association of Supervisors of State Banks, Bretton Woods, New Hampshire, September 18, 1962

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

by Government examiners. The private interest of owners and central managers in safeguarding against mismanagement, defalcation, and incompetence coincides with the public interest. It is possible to rely on this private interest and the licensed private accountants for these purposes.

Where the public interest continues to require examination of banks is in the matter of the adequacy of bank capital, and the quality of security and loan portfolios. Even here, however, security holdings, and to some extent capital adequacy, can be appraised at a distance from reports submitted by individual banks. The major function for on-the-spot examination is the appraisal of loan portfolios.

It is my contention that the judgments involved in examining bank loans are of a type that fit naturally into the responsibilities of the central bank. They are a natural extension of the central bank's concern for sound credit conditions.

These considerations regarding bank examination lend support to the proposal of the Commission on Money and Credit that bank supervisory functions be centralized in the Federal Reserve.

This proposal may also be supported on the grounds that the central bank has a strong interest in the structure and operation of the banking system, in part because the nature of that structure and operation affects responses to monetary policy. Furthermore, monetary policy gains from the intimate contact with banks that are involved in examination and responsibility for structural changes.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The major argument that has been advanced against centralizing these responsibilities in the Federal Reserve is that they would interfere with monetary policy formation. It is my view that delegation of responsibilities in accordance with established policies, if sanctioned by a revision in the law, could deal effectively with this problem.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

APPENDIX

Bank Concentration Ratios

A useful descriptive measure of the structure of an industry is the so-called curve of concentration. This curve is usually constructed by placing some index like per cent of total industry output, or total industry assets, or total industry employment on the vertical scale and the number of leading firms in the industry on the horizontal scale. The height of the curve above a given point on the horizontal scale, say, 4, will give the percentage of the industry's total output, or assets, or employment accounted for by the largest 4 firms. Conversely, the distance from some point on the vertical scale, say, 50 per cent, will give the number of firms necessary to account for 50 per cent of the industry's total output, assets, or employment.

The accompanying charts use this device in studying bank concentration in two groups of states: The ten largest states (by population) and, roughly, the ten middle-sized states. The percentage along the vertical scale is total deposits of a given state. Deposits constitute "capacity" to make loans and investments just as the physical plant of a steel company constitutes its capacity to produce a group of steel products. These curves might then be interpreted as the concentration of loan and investment capacity in leading banks. A very steep curve, such as that for California, indicates high concentration of loan capacity in few banks; a very gently rising curve, such as that for Iowa, indicates a low degree of concentration of loan capacity.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

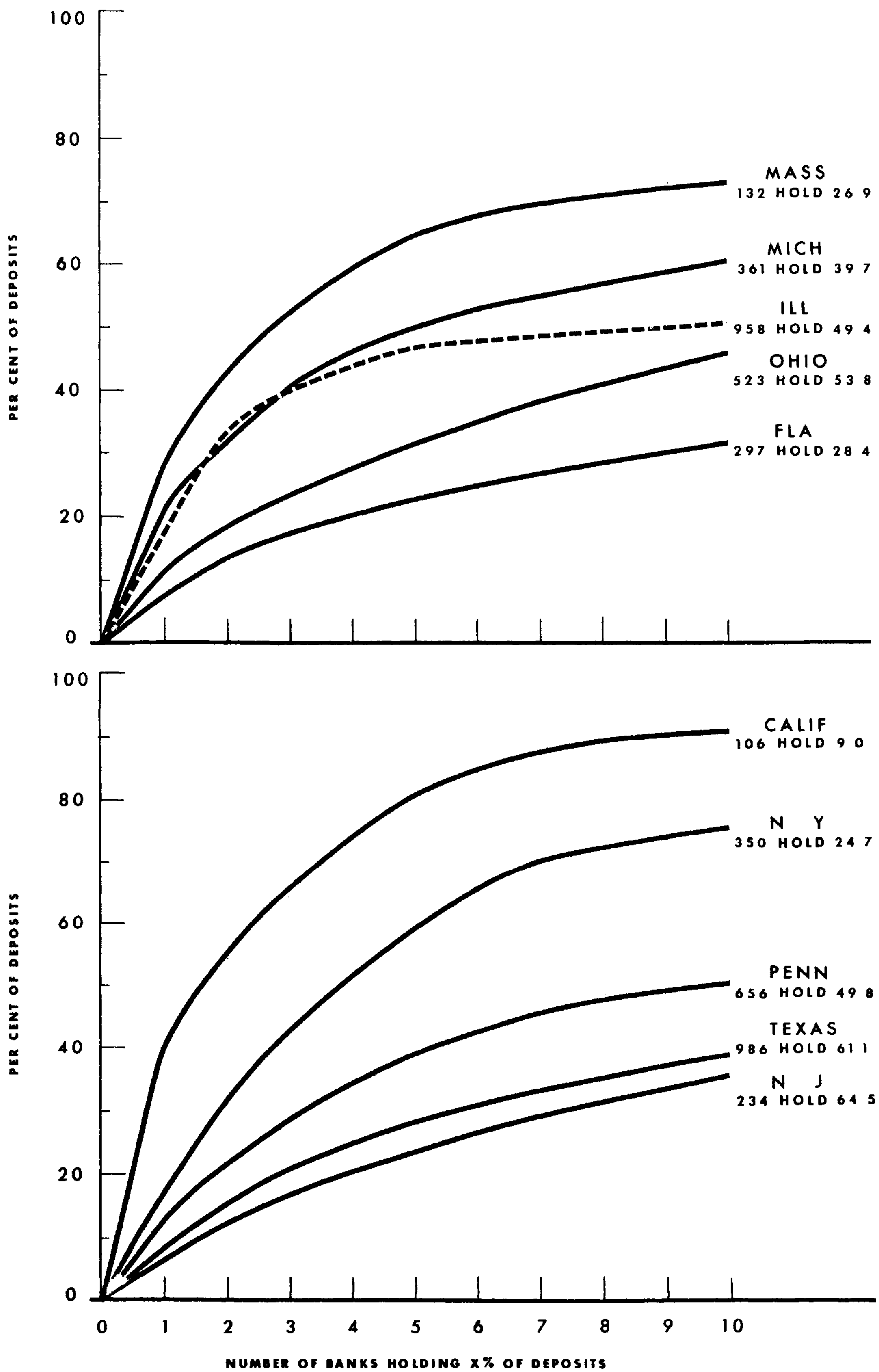
A very humped curve, such as that for Oregon, indicates a significant disparity in the sizes of the leading and remaining banks. The entry labeling each curve gives the state, the remaining number of banks, and the percentage of total deposits ("capacity") accounted for by these remaining banks.

Care must be taken in interpreting these data. Concentration curves do not show monopoly. They are meant to show potential market power which may or may not be exercised. More analysis is needed to say whether the existence of market power coincides with its use; whether high concentration is in general associated with monopoly effects such as high and rigid interest rates and low "loan output."

Concentration curves refer to a market, so that one must be very careful in drawing them up. Here we have implicitly assumed that the state lines form the boundary of "a" market. This may not be a bad assumption for some states but a rather poor one for others.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

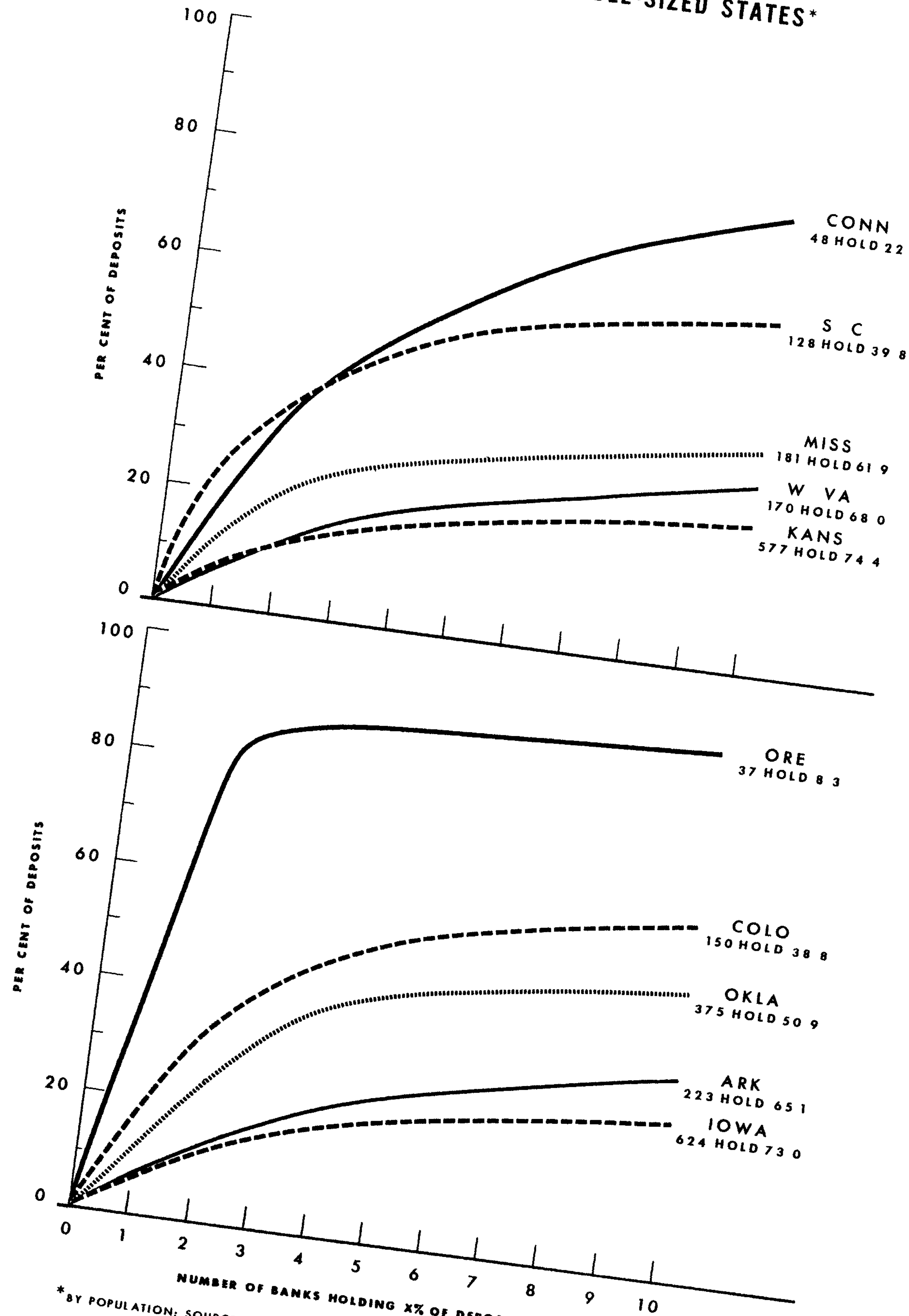
DEPOSIT CONCENTRATION IN THE TEN LARGEST STATES*
DECEMBER, 1961



* BY POPULATION; SOURCE: F.R.B. DATA INSURED COMMERCIAL BANKS

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

DEPOSIT CONCENTRATION IN TEN MIDDLE-SIZED STATES*
DECEMBER, 1961



*BY POPULATION; SOURCE: F R B DATA INSURED COMMERCIAL BANKS

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis