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THE CHANGING STRUCTURE OF BANKING

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In our competitive society customer allegiance is usually regarded as incontrovertible evidence that a business product or service is outstandingly meritorious. To attract even more customers a manufacturer or retail firm may endeavor to create the impression that its products are superior to those of its competitors simply because it already has more customers than its competitors. As we all know, banks use this ploy; total deposits or total footings are widely held to be evidence of superiority.

But as any thoughtful person knows, the measure of more--whether it be sales, assets, footings, customers, or whatever--may lead to spurious conclusions so far as the quality and price of the service or product is concerned. Size may be inherited. It may reflect consumer inertia. It may result from a monopoly position. Or, it could be the product of some kind of social hormone which fattens sales but has little to do with quality and the reasonableness of the price of the product.

It is hardly surprising that given present-day business practices, many banks have taken advantage of the impression that size is a proxy for quality and value of service. Rivalry among banks to appear to be first or to be among the "top 10" in their community, city, county, state, or the nation, though far from universal, is common today.

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Various means can be used to create an impression of bank size that is not realistic. Such "window-dressing," as a supervisor sees it around statement dates, may show up in an abnormally high level of large denomination CD's, repurchase agreements, Federal funds purchases, swollen "other liabilities" that reflect advances from foreign branches, and in some cases bulging public deposits. This game has its costs, of course, but it has a long tradition, both at home and abroad.

Operation of a large check clearing facility is another activity that can make a bank look significantly larger than would otherwise be the case. The primary incentive for undertaking such an operation may be its service and earnings potential, but I doubt that its side-effect on footings is regarded as useless fallout. Obviously, the larger the volume of items flowing through a bank's clearing facility, the larger will be the bank's deposit totals. But these totals do not indicate accurately the bank's size in terms of its ability to lend or invest because the totals include uncollected funds that are not investable. As a matter of fact, the nation's check collection system operates with about 20 per cent of gross demand deposits in an uncollected status. In fact, some banking institutions heavily engaged in clearing operations show as much as 50 or 60 per cent of their gross demand

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deposits as items in the process of collection. If their size were measured by collected deposits this float would be dispelled and the illusion of size and rank would be more directly related to its ability to finance its customers.

What troubles me here is not so much the thought that customers will suddenly see through this "window-dressing" illusion, and discover that bigger is not necessarily better. It is rather the thought that fixation on what may be irrelevant size data--both in banking and in the regulatory agencies--can blur our ability to make realistic judgments as to the level of a bank's public service, its competitive vigor, its stability and its resilience.

Most of us like to think we are able to recognize service and operating merits regardless of the size of the institution. For a regulator involved in passing on proposed merger and holding company acquisitions--at any rate certainly for this regulator--the detailed facts concerning a given application, rather than unrefined data on raw size, are crucial inputs for an intelligent decision. But this is not always easy to do--relevant facts are often not readily available, good analysts are comparatively few, and the institutions to be surveyed are very numerous.

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Conceivably--though I doubt it--an ambitious econometrician will one day derive coefficients that will enable us to predict from the size of a bank the probability that it will display any one of a number of favorable or unfavorable institutional characteristics. In the meantime, we can only avoid the more simplistic rules of thumb and give greater and more direct attention to environmental, institutional, and operating factors which we have reason to believe produce the kinds of banking institutions that regulatory authorities are supposed to encourage and nurture.

Nurturing banking institutions not only capable of achieving a superior level of public service but oriented in that direction is currently absorbing a good deal of regulatory attention at the Federal Reserve, the FDIC, the Comptroller's Office, and the Justice Department. And as a result the banking structure in several unit and limited branching states is undergoing a substantial transformation. In Alabama, Colorado, Florida, Iowa, Missouri, and Texas, where banking structure had changed little since the 1930's, recently organized holding company systems have been reaching into most of the major centers of each state. In some of these states the total of deposits in banks affiliated with holding companies has already, or will shortly, outstrip deposits in unit banks.

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In Ohio and New York, where holding company growth had for a time virtually ceased, new holding companies are coming into existence and old ones are being expanded. The limited branching states of New Jersey and Michigan have recently made state-wide coverage possible for holding companies. Acquisitions to achieve this end are being made in New Jersey and just getting under way in Michigan.

My own observation of experience in these states leads me to believe that the holding company form of organization will shortly spread to all states where legal constraints have, up to now, prevented state-wide branching or holding company operations. The operating and economic advantages of holding company organizations and the impetus gained from the experience of states where it has been widely used are forces that are unlikely to be stopped or diverted. They will bring about a striking change in the banking structure of other unit and limited branching states in a very short period of time. This does not mean, of course, that unit banks will disappear. There are and have been many unit banks even in the state-wide branching states in the West and East. There will continue to be many one-bank towns and most of these will be served by unit banks. However, unit banks in the nation's metropolitan areas will be competing with holding company systems that seem certain to become the dominant type of banking organization in most unit and limited branching states.

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In a table that is appended to my remarks, I have tabulated the market shares of the largest, the second and third largest, the fourth and fifth largest, and sixth through tenth largest banking organizations (banks or holding companies) in each of the 36 largest banking states. The market shares are measured conventionally by total deposits and are shown for June 30, 1961 and June 30, 1971.

The purpose is first to compare deposit concentration in states with unit banking with that in states with state-wide branching, and in states where holding companies have been active, usually limited branching states, and second to examine the changes in banking concentration that have taken place over the past decade.

As I indicated earlier, window-dressing distorts the kind of data shown in the table. But even without window-dressing, deposits are a clumsy tool for measuring market shares. I would prefer, for example, to use the quantity of total assets less cash items and due from banks (Item 1 on the call report). This measure has several advantages if the concentration of investable resources is the objective of analysis, since it would include capital and borrowings as well as deposits and would exclude float, non-earning assets, and deposits with other banks that they invest.

In addition, in using state-wide concentration ratios, it needs to be recognized that the markets for loans, investments, and deposits of most small- and medium-sized banks are, in fact, mainly local. But even local markets in many cases straddle state lines.

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Larger banks, of course, are actively involved in competition for regional business and state boundaries are generally poor definitions of regions. For the largest banks, much--sometimes most--loan and deposit business is derived from a truly nation-wide market.

For numerous reasons, then, it should be obvious that a really adequate analysis cannot be developed using state-wide deposit concentration ratios. Despite all their shortcomings, such ratios are still probably the most widely used measures for the analysis of banking concentration, perhaps because they are so readily available. In using the total deposits measure of concentration I do not intend to imply it is satisfactory or even appropriate for the purpose of drawing substantive conclusions. In fact, it is an aggregate that has a far wider acceptance than it merits.

I have arbitrarily divided the 36 states in the table into two groups: those in which there has been little or no merger and holding company activity in the past decade and those where activity has been widespread, particularly in the formation and expansion of holding companies. The inactive states (in a sense the control group) are subdivided into "unit banking," "limited branching," and "state-wide branching" states.

The levels of concentration differ among the states depending upon statutory constraints on branching. In the unit banking states other than Minnesota, where long-established holding company patterns distort the data, the market shares of the top three banks taken

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together range from 11 to 35 per cent. For limited branching states the share of the top three banks taken together is over 40 per cent in Massachusetts, Georgia, and New York. In state-wide branching states the top three banks' shares begin near 40 per cent and range up to 70 per cent except in Arizona and Oregon where they are between 80 and 90 per cent.

The shares of the largest 10 banks taken together exhibit the same pattern, with the state-wide branching states ranging up from 70 per cent and the unit and limited branching states ranging down from 60 per cent, with two notable exceptions: New York 82 per cent and Massachusetts 74 per cent.

The astounding inference to be drawn from these facts on market shares is the implicit acceptance or acquiescence by the banking public of an enormous range in concentration ratios. The ten leading banks have as little as a fourth of total deposits in some states and as much as 100 per cent in others. The state's largest bank has as little as a 5 per cent market share in two states and over 40 per cent in two others. How do these disparities square with strongly expressed concerns by regulators over banking concentration?

There is no clearly visible evidence of differences in banking accommodation among states with widely different concentration levels other than the convenience effect of a larger number of offices relative to population in the branching states. There is no outcry

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of frustration from bank customers in states with high concentration ratios and no groundswell of customer satisfaction with the status quo in states with low concentration ratios. If anything, customers in states such as California have been the beneficiaries of more innovative services and banking conveniences than customers in states with low concentration ratios where, for example, agricultural enterprises have complained about the inadequacies of bank credit to meet seasonal and longer term needs. Do these ratios, then, measure competitive advantages and disadvantages as they show up in services and pricing? If so, they do it very poorly.

It seems, rather, that banking competition in the numerous service and product markets in which banks participate is less affected by the number of local banking alternatives than it is by operating policies of nonlocal banks and nonbank institutions, such as savings and loan associations, finance companies, and other financial institutions, and by the nation's money and capital markets and even by regulatory authorities' actions on interest rate ceilings.

We tend to think of our banking system as being linked to the locale of 37,000 banking offices but more and more bank customers, both business and household, do not feel so constrained. They can respond to advertised terms and conditions for a variety of banking services that are as independent of state lines as TV broadcasting or newspaper circulation. In this sense competition is regional or even nation-wide.

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To my mind, the most striking fact revealed by the table is that in nearly all states the change in market shares of the top banks over the decade was relatively slight. Only in Virginia and Maine did either the three or five largest banking organizations show substantial gains in market shares.

By and large the front-runners--that is, the largest banks--in both active and inactive states lost ground. In the active states, however, the losses tended to be smaller; several banks held their shares; and two registered significant gains.

The place and show banks generally did a little better than the front-runners, increasing their shares in half of the inactive state-wide branching states and over a third of the active states. The best gains were recorded by banking organizations ranging 5th to 10th; in all except eight of the 36 states banks in this range held their own or gained.

One may doubt whether the front-runners or the runners-up were, or at least should have been, dismayed by the downward trend in their market shares; many of them have realized their growth objectives by expanding into foreign operations, by using nondeposit sources of funds, and by extending their corporate activities into related fields and wider geographical markets. None of this, of course, is reflected in the ratios based on total deposits.

From all of this can it be inferred that the concern about banking structure of the regulatory agencies and the Justice Department in the past decade has been exaggerated?

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I believe it has. Weighing the pros and cons on the issue is, however, a matter of judgment. In my view the major plus gained from regulatory concern with concentration ratios has been the forbearance that regulatory attitudes has created in the expansionist policies of those institutions who obviously aim at sealing off as much competition as possible. Clear illustrations of this type of merger or affiliation do not even get into the application stage; few are even conceived of in the present environment. As a corollary to this proposition expansionist institutions have redirected their energies into other areas or activities and are often reconciled into entering promising new markets on a _de novo_ basis or through foothold acquisitions.

On the minus side regulatory zeal has sheltered weak competitors to the disadvantage of their customers. Anti-competitive arguments based on concentration ratios have been used to halt mergers and holding company acquisitions that would have been pro-competitive by strengthening the capability of the merged or affiliated unit to become a strong competitor instead of remaining a marginal or sheltered institution. "Problem" banks aside, there are many institutions that lack management or management opportunities because of the limited scale of their operations relative to the market they are attempting to serve.

A competitive banking system must be based on the _capacity_ to compete. For many types of services this capacity requires large size. It also requires considerable talent. An arena of sufficient

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scope must be provided for the exercise of that talent and for its development. The alternative is some sort of sheltering--the kind exemplified by statutory home office protection and regulatory proscription of over-banking. If we believe that competition will provide higher quality and lower prices for banking services then we cannot assume that the requisite competitive talent will be attracted by a dead-end future.

The evaluation of the public interest in a proposed merger or acquisition is one of the most difficult and controversial problems regulatory authorities have to deal with. Strange as it may seem, bank customers seldom bother to volunteer a view pro or con on such cases, even if their opinions are solicited in a neutral fashion. Opinion evidence on service and competition is generally confined to that of bankers directly affected.

The evidence bearing on competitive conditions is largely judgmental and inferential, based on factors such as proximity of competitors and comparative market shares. Far too little is known about the quality of services rendered, and the effects of growth and size on this quality. Despite these difficulties regulatory authorities have, in my opinion, done more overall to improve than to worsen the competitive environment in many of the country's banking markets. Not the least of their accomplishments may have been to evolve criteria--admittedly crude--which have supplanted blind adherence to simple concentration ratios as the sole basis for

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judging the public interest effects of mergers and acquisitions. Especially with the resurgence of holding company growth, there is before us an opportunity to ignite the sparks of competitive vitality in commercial banking, at a time when the industry is ripe for change.

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CHANGES IN MARKET SHARES OF PRINCIPAL BANKING ORGANIZATIONS

State	Market Shares as a Per Cent of Total State Deposits: Largest		2nd & 3rd Largest		4th & 5th Largest		6th thru 10th Largest		Total State Deposits (billion $)	
	1961	1971	1961	1971	1961	1971	1961	1971	1961	1971
States with Little Merger and Holding Company Activity										
State-Wide Branching States:										
Arizona	47	44	48	45	3	7	2	4	$ 1.3	$ 3.9
California	41	38	24	23	17	16	10	11	24.7	51.5
Conn.	18	19	24	28	14	14	21	23	2.3	5.2
Maryland	17	18	24	23	16	19	10	15	2.3	5.6
N. Carolina	23	20	25	31	10	17	9	13	2.6	7.4
Oregon	44	42	43	41	2	4	3	5	2.0	4.0
S. Carolina	25	22	19	23	9	12	8	13	1.0	2.5
Washington	35	32	27	31	12	14	15	10	2.8	5.7
Limited Branching States:										
Georgia	21	19	27	22	9	8	6	6	2.8	7.5
Indiana	10	9	14	13	5	5	8	7	4.7	11.0
Kentucky	11	10	16	14	7	7	8	9	2.2	5.5
Louisiana	15	9	15	12	11	7	13	15	2.9	6.9
Mass.	28	26	21	23	15	16	8	9	5.2	11.1
Michigan	21	19	19	18	10	10	10	12	8.8	21.9
Pa.	13	11	15	13	11	10	11	15	14.2	29.4
Unit Banking States:										
Illinois	16	15	19	18	7	6	6	5	17.2	36.7
Kansas	7	5	7	6	5	4	7	7	2.4	5.2
Nebraska	14	10	17	15	10	9	5	5	1.6	3.6
Oklahoma	10	8	18	14	10	9	7	7	2.6	5.8
Texas	8	6	13	10	6	6	11	9	11.8	26.8
West Va.	6	5	11	8	5	5	10	9	1.3	3.1
States Where Principal Merger and Holding Company Activity Has Taken Place										
Alabama	17	12	13	12	10	8	11	14	2.0	5.2
Colorado	15	15	22	20	11	12	9	13	2.0	4.6
Florida	7	8	10	12	5	9	9	12	4.8	14.7
Iowa	7	6	7	6	5	5	7	7	3.0	6.8
Maine	14	17	20	27	14	22	22	21	.6	1.3
Minnesota	29	29	29	27	5	4	3	3	4.1	9.4
Missouri	10	9	17	16	9	8	12	10	5.8	11.5
Montana	30	28	18	21	9	9	9	7	.8	1.7
New Jersey	6	6	10	10	7	8	12	14	7.2	15.7
New York	16	16	24	25	15	17	22	24	43.2	94.7
Ohio	12	10	13	13	9	10	14	15	11.0	22.0
Tennessee	11	10	18	18	13	12	17	17	3.2	7.8
Utah	33	30	32	30	12	12	8	11	1.0	1.9
Virginia	8	14	12	21	8	16	12	19	3.2	8.5
Wisconsin	19	16	12	13	2	4	5	6	4.5	10.0

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