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Concentration Ratios and Banking Competition

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Measuring Banking Competition

The efficacy of competition is firmly engrained in American economic and social philosophy. Competition is viewed as the stern but successful taskmaster of our business system, promoting innovation, driving down prices, and inducing entrepreneurs to adjust to the changing needs of their customers.

To be sure, in some industries fraught with a special public interest, certain extremes of competitive behavior have been restrained by law and regulation. In the banking business, entry, branching, and merging are all regulated to guard against predatory practices. Extensions of credit are scrutinized by examiners for quality and conformance to statutory requirements. Within the kind of Marquis of Queensberry rules established for the banking industry, however, the public interest favors a vigorous competitive attitude among bankers.

Whatever beliefs to the contrary might once have been held, the Holding Company Act of 1956 and the Bank Merger Act of 1960 clearly articulate competition as a goal for banking. Recent court cases have gone even further, saying that the pro-competitive strictures of the two main trust-busting statutes, the Sherman and Clayton Acts, also apply to banks as they do to nonregulated industries.

These court rulings have been greeted with considerable misgivings by some elements of the industry, Congress, and the public. Their misgivings are not, I am sure, based on any repudiation of the beneficial consequences of competition--that conviction is too firmly rooted. Much of the differences of opinion, I am convinced, stem from conflicting judgments about how to resolve a very knotty problem in each case, namely, the evaluation of comparative competitive situations in which competition is already diluted by structural limitations and regulatory restraint.

How can one judge whether a given banking situation is more or less competitive than another when neither meets the requirements of perfect competition? Many cases present no particular problem because, by whatever criterion, no difference in the competitive situation can be detected. In other instances, however, that judgment will depend heavily upon the measurement of competition employed.

A favorite yardstick for measuring levels and changes in bank competition is the so-called concentration ratio. Just what is meant by a concentration ratio? The concentration ratio most often used in banking relates the proportion of deposits or assets held by one or a few of the largest banks to the total for all banks in the market;

whether that be construed to cover all banks in the city, the country, the metropolitan area, or the State.

The concentration ratio concept is actually fairly new. Back in the late 1930's, concentration ratios were developed for a large number of major industries in a massive study of the structure of the American economy by the Temporary National Economic Committee. Since that study, the concentration ratio has received wide use by academic scholars, Government agencies, including the Department of Justice, and the Courts.

Wide and continuing use in antitrust proceedings has given concentration ratios the respectability of age and association. They have their detractors, however, who emphasize the shortcomings of the ratios both as a measure of market structure and as an index of competitiveness in a market.

Some of the popularity of these measures may lie in their simplicity for all they really show is the relative size of a particular bank by comparing it with the total for all banks in a particular area. The larger the ratio the greater the concentration and the more compelling the presumption of anti-competitiveness.

Solving a problem by quantifying its dimensions and characteristics is the essence of using our growing knowledge constructively. The more skillful we become at using numbers to describe economic relationships the greater the likelihood of being able to deal with our more intractable problems. But concentration ratios as ordinarily used do very little by way of focusing or reinforcing our judgment about competition in banking--in fact, they often warp that judgment. This is clear if we consider for a moment whether banks are Sui generis competing only among themselves in the services they provide to lenders, depositors or borrowers. Obviously most such services are available from other sources. Individuals and corporations are not confined to banks alone either as sources of credit or as outlets for their savings. Banks provide only one unique service of major importance, the checking account. All other bank activities are subject to varying degrees of nonbank competition and the denominator of the concentration ratio should reflect that fact.

The Supreme Court has leaned heavily on the concentration ratio in recent antitrust cases, including the controversial Philadelphia National Bank case. In that case, the Supreme Court adopted the view that "the cluster of products and services denoted by the term 'commercial banking' composes a distinct line of commerce."

This is not my view of the banking industry. Simply because banks operate in at least a score of different markets, the competitive situation is likely to be different in each one.

I recognize that the Court's concept of banking is one that is held by some bank supervisors, bankers, and academic scholars, but in my judgment this is a quite untenable position for the analysis of banking competition. This does not mean that recent decisions were necessarily wrong nor does it mean that the Court would have decided any recent cases differently if it had adopted a different view of commercial banking. It only means that I would advocate looking at the question of the extent of banking competition from a completely different perspective.

Let me illustrate the core of my objection to using a single concentration ratio as an indicator of competition among banks. No doubt many of you promote yourselves as full-service banks. Your customers could, if only they would, do all of their banking business at one stop. But they don't--perhaps much to your chagrin. To be sure, some use several of the services you provide. Businesses frequently borrow from, and maintain demand deposit accounts at the same bank. But it is clear that few customers use all or even most of the services offered by a single bank. And what is more important, most of them do not transact all of their banking business, in the broadest sense, at a single institution. Banking products and services do not constitute a neatly bound and inseparable bundle. The total includes many distinct and separate components among which customers choose as they will.

To appreciate how markedly different this view of banking markets can be, let us focus our attention briefly on one after another of the major bank earning assets and liabilities. Business loans are a good place to begin, for they are a credit of key economic significance. A major difficulty arises at once: what business loan aggregate to use as a base for comparison? In one business loan market a bank may be competing with several large U.S. banks and any number of foreign banks for business in Japan or Latin America. In another market, it may be competing with fifty or more U.S. banks, the capital markets, several large insurance companies and pension funds for a loan to a large U.S. firm selling its products nationwide. Or in its most localized market, the bank may need only to face the competition of one or two local banks, trade credit from suppliers, and equity funds from friends and relatives.

In the first two of these business loan markets, the concentration ratios are bound to be small, even if they include the biggest banking institution on either coast. This is because almost all large U.S. banks are competitors, as well as insurance companies, pension funds and capital markets--in fact the base for the ratio should probably be the total of external funds available or in use. In the third kind of market, for localized business credit, concentration ratios covering the one or a few largest local lenders can sometimes be quite high--quite high enough to raise the presumption of potentially anti-competitive bank structure. But I would maintain that it is a patent absurdity to add up the figures for all three of these markets, strike an average, and call that the representative concentration ratio for the "business loan" market.

Much the same sort of market structure exists in bank lending to governments: Federal, State, local and foreign. In these markets it might be useful to add another type of subdivision of the market based upon the term of the credit (a similar substructure could also be used for business loans). Thus relevant concentration ratios might be based not on a bank's total holdings of Governments but on its participation in three markets: Treasury bills, intermediates and longer term issues. In each case the denominator is obviously not the comparative holdings or participation of other banks in the area or even the Nation, but upon the holdings of or trading in all such securities by all types of investors conceivably even including the Treasury trust accounts and the Federal Reserve's portfolio.

Because tax exempt securities are so widely traded among individuals as well as banks, concentration ratios for this credit activity of banks ought also, excepting for purely local issues, to be compared with nationwide outstandings or activity. The bonds of small governmental units and short-term borrowings of medium-sized units, on the other hand, often are sold or traded in a very limited market. Quite likely banks in the community or in communities close by are the principal sources of funds, a fact that can be established by an appropriately constructed concentration ratio for such limited credit use.

It should be clear from these illustrations that the whole array of alternatives for bank investment can be similarly examined and broken down into submarkets with the pertinent areas defined in light of the facts of bank and nonbank competition. If this is done it will be found that in the extension of credit banks are often confronted with more nonbank and nonlocal bank than local bank competitors. Banks are a minor factor in so many particular markets as a result in considerable measure of the broad lending powers given them. It is this freedom of investment that encourages them to enter a great variety of credit markets, constantly shifting their preferences to those loans or instruments where rates and terms are most attractive. This general situation is further reflected in their widened competitive influence geographically as they have reached out from their home territories for regional, national and even international business.

On the other hand, those banks that attempt to serve the local credit requirements most intensively often provide significant competition to nonbank lenders in local markets, mainly in loans to small and medium sized business, agriculture and consumers. Bank rates to these types of borrowers tend to be lower than nonbank rates, but the quality of the paper banks hold tends to be higher, thus offsetting some of the apparent advantage of bank lending.

In my judgment, studies of concentration in the markets where banks act as lenders are not likely to uncover very many kinds of credit on which a merger between local banks would have a large anticompetitive effect. And concerning the few types of credit--ordinarily local--for which such a merger might significantly raise concentration ratios, intensive analysis is essential in order to appropriately assess the overall competitive effects of the merger.

The role of banks as lenders usually receives primary attention from those who are looking for the anticompetitive effects of prospective bank mergers. But banks are also borrowers--from a number of markets--and it is in one of the markets where they obtain funds that the threat of concentration is most likely to be found. In referring to banks as borrowers, I do not have in mind their borrowings in the federal funds market, through repurchase agreements, from the Federal Reserve, or from the issuance of notes or debentures. I refer rather to the deposits they obtain on either a time or demand basis. In the case of time deposits, interest payments are contractual; in the case of demand deposits compensation to the depositor takes the form of a variety of services connected with money payments and a conveniently safe storage for liquid funds.

When commercial banks borrow money by paying interest on time accounts--savings or certificates of deposit--they must meet a great deal of nonbank competition from savings and loan associations, mutual saving banks, direct investment opportunities in government securities, equities, and even contractual commitments to insurance companies and pension funds. But there are some banking markets where nonbank competition is either non-existent or is not very vigorous so far as savings deposits are concerned. This can be inferred from the reaction of the Nation's bankers to the most significant change in Regulation Q in recent years--that of January 1, 1962. According to a survey made at that time only about one-half of the member banks increased their rates of interest on regular savings accounts during the first two weeks after the ceiling was raised, and only 40 per cent who raised their rates went immediately to the new 4 per cent ceiling. However, as many of you, as Wisconsin bankers, know banks in some states meet the toughest competition by steering the straying customers from regular savings accounts into certificates of deposit.

When banks "borrow" money by providing services to demand depositors they are in a market in which the only nonbank competition--and not a very satisfactory substitute--comes from coin and currency. Actually the bundle of conveniences and outright necessity inherent in a demand deposit account has no true counterpart in the service offered by any other financial intermediary. Hence the analysis of the competitive factor in this particular market depends solely upon the availability of service from other banks.

In recent years, competition among banks for business demand deposits has spread out over larger and larger areas as corporate business has grown by diversification, decentralization or branching into more states and communities. National and regional businesses now have scores of banking connections and are constantly being importuned to add others. Today competitiveness among banks for these types of accounts is no longer local but at least regional or nationwide. It is doubtful that any likely merger proposal would significantly change the concentration ratio in the market for these types of demand accounts because the denominator would encompass so large a number of alternatives open to the alert corporate treasurer.

Local demand deposit customers, on the other hand, have no such wealth of alternatives for banking accommodation. Most of them depend upon local banks or offices of branching institutions. They rate convenience to their home, office, or shopping center as a major factor in determining where they bank. It is a goal of public policy to provide these customers with as many alternatives as are practicably consistent with economy and efficiency.

How helpful are concentration ratios in evaluating the effects of mergers on this banking market?

I can illustrate the differing results that can be obtained by drawing upon the information on size of account collected periodically by the Federal Deposit Insurance Corporation. The Corporation obtains from each bank the number and total of its deposit balances in accounts under $10,000, between $10,000 and $25,000, between $25,000 and $100,000 and over $100,000. Suppose we assume that any depositor with less than $10,000 in the bank is fairly well confined to local banking alternatives, and, on the other hand, that any individual or firm with more than $100,000 on deposit is a sufficiently desirable customer to be sought after with various service appeals not only by his local banks but also by a goodly number of other banks from nearby towns and cities. On this basis, the pertinent concentration ratio for the local demand deposit market should certainly exclude balances over $100,000, and it might also be instructive to calculate a "hard core" ratio based only on demand deposit balances under $10,000.

In a city like Milwaukee, this means that we are talking about a concentration ratio for the three largest banks of 56 per cent for demand deposits under $100,000, and 47 per cent for deposits under $10,000, compared with a ratio of 69 per cent if one simply looked at all their demand deposits taken together. For Chicago, your neighbor to the south, the contrasts are even sharper. There the three top banks account for but 24 per cent of demand deposits under $100,000 and only 13 per cent of accounts under $10,000, as opposed to a 49 per cent share of all the area's demand deposits combined. On the other hand, in some other Midwestern centers where city-wide branching prevails, the ratios suggest that the large banks' shares in the various deposit markets are much less disparate. Thus, in Detroit, the three biggest banks hold 73 per cent of total demand deposits, 65 per cent of demand accounts under $100,000, and 60 per cent of accounts under $10,000; for Indianapolis, the corresponding ratios are 83 per cent, 75 per cent and 67 per cent, respectively.

I am sure that using size of account as a proxy for sorting out local accounts with limited access to nonlocal banks is not as accurate as a direct determination of the actual or potential banking radius of each depositor. But I think such numbers as I have reported provide dramatic evidence of how differing the market position of leading banks can be in the local as distinct from the aggregate total deposit picture in any particular community. Attention to such size-of-account concentration ratios would be useful in every merger or holding company case, as a simple means of obtaining an indication when the concentration of locally limited bank deposits may be markedly different from what is suggested by overall deposit totals.

In the last analysis, concentration ratios in any form are best utilized as indicia--warning lights whose flashings can alert regulators to the need for a more intensive probing for present and potential anti-competitive effects in the particular banking markets under review. Once in a while the complexity of relationships involved or the paucity of obtainable evidence may force the authorities to fall back upon presumptive judgments or inferences based in part on concentration ratios, but in my own view these occasions need be relatively infrequent.

In whatever way their signals are employed, however, I think it is imperative that concentration ratios be refined to distinguish between the differing customer markets for differing bank services. Any other usage substantially heightens the risk of mistaking shadow for substance--in a field that already is haunted by too many ghosts!