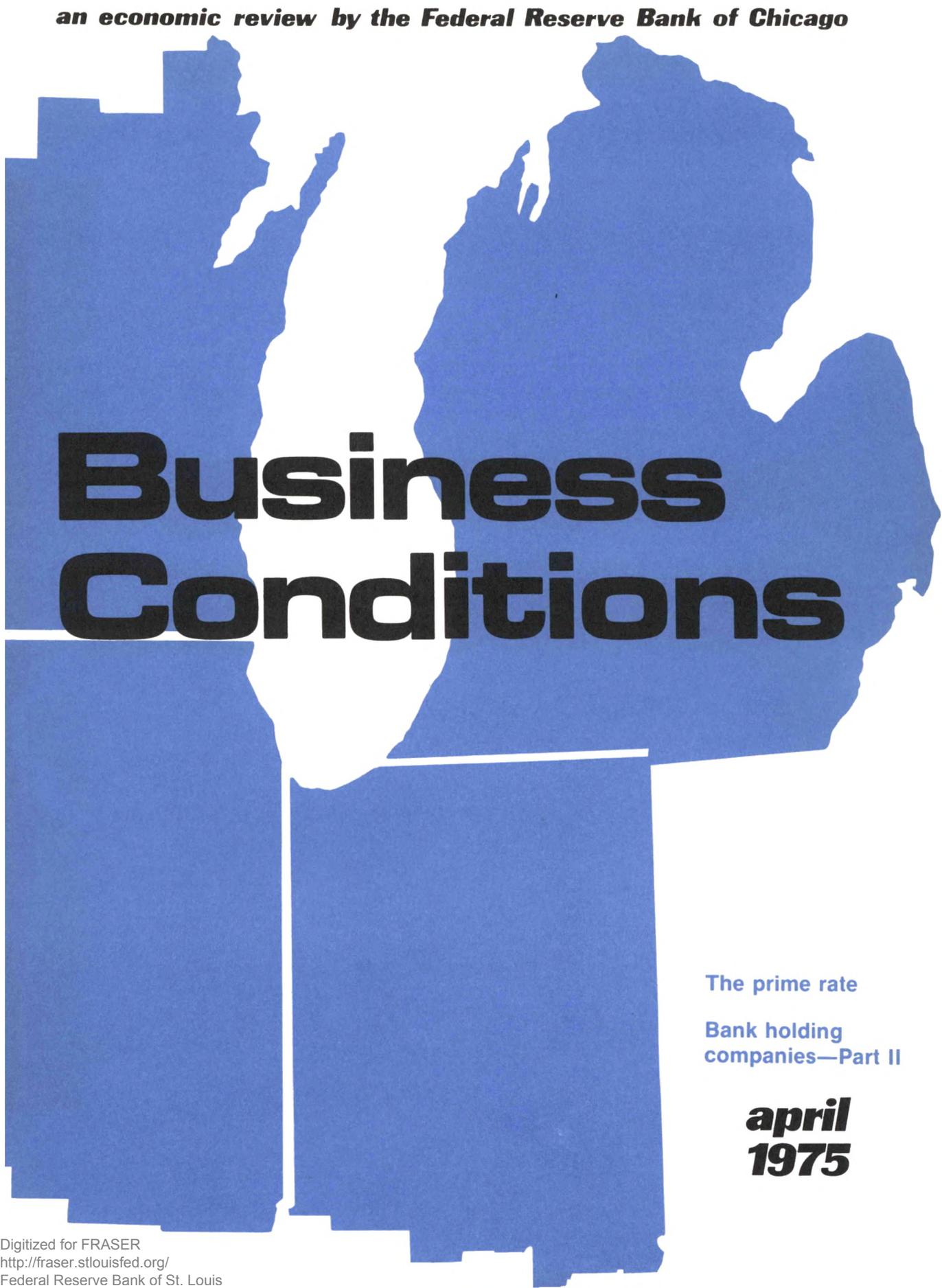


an economic review by the Federal Reserve Bank of Chicago



Business Conditions

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companies—Part II

**april
1975**

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The prime rate made news last year when it rose to record-breaking levels. But other, less dramatic developments have altered the very structure of the prime rate convention over the past few years.

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*This article focuses on potential competition as a factor cited increasingly by the Board of Governors in orders denying holding company acquisitions. An article in **Business Conditions**, February 1975 examined the issue of capital adequacy and its influence on Board denial orders in recent years.*

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The prime rate

Never in its 40-year history has the prime rate—the interest rate charged by large banks on business loans to their most creditworthy customers—received more publicity than in the past two years. In July 1973 the prime rate was boosted above the previous record high of 8½ percent. By July 1974 the prime reached its current all-time high of 12 percent and remained at that level until late September 1974.

Because it is so widely viewed as a barometer of conditions in the nation's money and capital markets, the prime understandably attracts considerable attention when it rises to record high levels. In recent years, however, there also have been significant innovations in the structure of the prime rate convention itself. These have resulted from the interaction of money market forces, commercial banking practices, and the actions of the federal government.

The introduction in the latter part of 1971 of a formula, or “floating,” prime rate—a rate explicitly linked to market-determined interest rates—added a new dimension to the prime rate concept. Another significant modification occurred during the first half of 1973 with the adoption of a “dual” prime system composed of a “large-business prime rate” and a “small-business prime rate.”

Other less dramatic developments also have altered the longstanding prime rate convention over the past few years. Traditionally, prime rate changes were initiated by one of a few major commercial

banks in New York City and prime rates at large banks across the nation were brought into line within a few hours or, at most, days. As prime rate adjustments occurred more frequently in the late 1960s and early 1970s, the initiative shifted to more banks in regional money centers. In the same period a uniform prime was replaced by different rates prevailing for a week or more at a time at different banks.

The prime tradition

The modern prime rate has followed the generally upward trend and major cyclical fluctuations of market rates ever since it was first adjusted from 1½ percent to 1¾ percent in December 1947. However, the prime rate has moved much less frequently than market rates and has lagged a month, a quarter, or even farther behind those rates. The prime has been less volatile than open market rates mainly because of its administered nature. Whereas market rates vary in direct response to demand/supply forces, the timing and the magnitude of changes in the prime rate are at the discretion of a relatively few large commercial banks.

While temporary differentials between the prime and other rates are partially explained by its administered nature and lagged behavior, persistent spreads between the prime and other rates reflect primarily the differing characteristics of the various debt instruments—maturities, risk factors, administrative and selling

costs, dollar denominations, and methods of yield calculation (discount vs. bond-yield basis), among others.

Setting the prime rate

Determining its prime rate is one of many decisions a large bank makes in the continuous process of managing its balance sheet—i.e., its asset portfolio and liability holdings. Three broad categories of market rates provide major inputs into these decisions: (1) rates on nonloan bank assets, (2) rates on bank-acquired liabilities, and (3) rates on corporate debt claims issued in lieu of bank borrowing. Because

bank loan contracts remain in effect until specified future dates, bankers' expectations concerning the future course of market rates are more important than current rates in the prime-setting decision. Other important considerations are expected growth in deposits—the major source of bank funds—and expected loan demand.

Several institutional characteristics of bank administration also have a profound influence on the prime-setting process. A decision to alter the prime rate involves adjustments in a bank's schedule of business loan rates. Nonprime rates typically are determined by tying them directly and for-

The origin of the prime

The prime rate is a nominal, or stated, per dollar price of bank credit. Although quoted as a per annum rate, it applies most frequently to short-term loans with maturities of less than one year. Like other interest rates, its economic function is to ration limited supplies of funds to a particular class of users—specifically, bank funds to those business customers who are least likely to default on repayment. The prime rate also serves as a base for calculating credit charges on loans carrying above-prime rates.

The prime can be viewed as a wholesale credit price since it is officially posted only by the largest banks and generally applies to corporate borrowers of the highest credit standing on large-volume loans, often in units of \$1 million or more.

In the early Thirties the “prime” credit classification was already familiar to investors who, for years, had dealt in prime, or “highest grade,” debt instruments (e.g., Aaa corporate bonds). In fact, commercial banks posted

“prime rates” prior to 1933, but these were not publicized and varied from region to region and from bank to bank. (The Federal Reserve System prime rate series includes data back to 1929.) By contrast, the modern 1½ percent prime was advertised by most major banks.

With the contraction of business activity, demand for business loans had slackened by 1933. Large commercial banks, replete with excess reserves (funds available for immediate expansion of bank lending), perceived a “price war” developing from over-zealous attempts to attract the few remaining low-risk loan customers. To avoid this calamity for their earnings, large banks introduced the 1½ percent prime, which was considered the minimum profitable return on lending after deducting administrative costs. Congress was eager to revitalize commercial banking especially by limiting “excessive” competition in the industry. As a result, the bank-imposed floor on loan rates via the prime rate convention soon became an accepted feature of bank lending.

mally, or indirectly and informally, to the prime. Thus, a bank must consider expected demand for nonprime loans in establishing its prime rate.

A bank's "customer relationships"—the arrangements whereby a bank provides a variety of services to its long-established clientele—also must be considered in setting the prime. A banker must be concerned with the long-run profitability of the "total customer" and, therefore, is loath to make frequent rate adjustments that might jeopardize customer loyalty. The usual customer relationship includes two features that are especially relevant to prime rate decisions—

compensating balance requirements and a bank credit line.

Role of compensating balances

Compensating balances are minimum average checking account balances that bank customers agree to maintain as partial remuneration for an array of bank services. Although compensating balances earn no interest return, typically they do qualify business customers for credit lines—prearranged agreements whereby banks extend credit on demand up to specified amounts.

Compensating balance requirements

Prime rate highlights

Late 1933—A nationally uniform prime rate of 1½ percent is adopted.

December 15, 1947—The prime rate is increased from its original 1½ percent to 1¾ percent by Bankers Trust Company.

August 20, 1956—The initiative for prime rate revisions moves outside New York for the first time with a change by the First National Bank of Boston.

August 6, 1957—The prime rate is increased by 50 basis points (½ of 1 percent) by Bankers Trust Company. All previous changes had been in 25-basis-point steps.

December 6, 1965—The First National Bank of Chicago becomes the first non-Eastern bank to initiate a prime rate revision—the first change since August 23, 1960.

January 26, 1967—The first "split" prime rate (i.e., different primes in effect at various money market banks) develops when Chase Manhattan Bank lowers its prime and other banks do not follow. The split lasts two months.

June 9, 1969—The prime rate is boosted from 7½ to 8½ percent—the largest single move in the history of the rate.

October 21, 1971—First National City Bank introduces a "floating" prime linked directly to market rates.

Late February 1973—Use of the floating prime is suspended due to banks' inability to reconcile the concept with rising market rates and the desires of the Committee on Interest and Dividends (CID).

April 16, 1973—The CID issues 14 guidelines which, among other things, establish a "dual" prime rate.

April 19, 1973—First National City Bank reinstates its formula prime.

September 13, 1973—Wells Fargo Bank in San Francisco posts the first double-digit prime, 10 percent.

December 3, 1973—The First National Bank of Chicago adopts a decimal point prime rate, 9.90 percent.

July 3, 1974—Bankers Trust Company moves its prime to 12 percent, the highest industry-wide rate to date.

also serve to raise “effective” loan rates. Although requirements usually are stated as percentages of dollar amounts of credit lines, many arrangements require the deposit of additional balances when credit lines are activated or used. Nominal loan rates at banks are quoted in terms of the dollar size, or principal, of the loan. If a borrower uses part of the loan proceeds to meet compensating balance requirements, the “effective” loan rate on the funds actually available for the borrowers’ use will exceed the stated rate because the borrower is paying loan interest on funds committed to remain in his deposit account. By increasing compensating balance requirements, banks can raise “effective” loan rates and thereby ration credit without changing prime rate quotations.

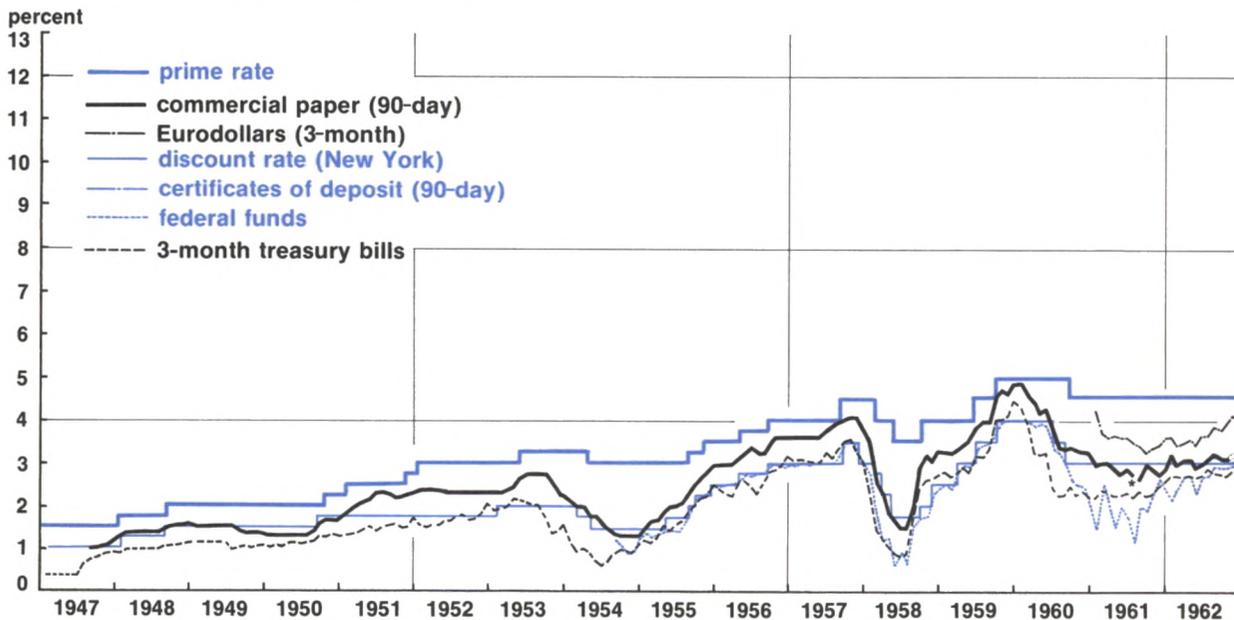
Other methods whereby banks can trim the flow of credit without altering loan

rate schedules include reclassifying borrowers from lower- to higher-risk classes (ones carrying higher loan rates) and varying one or more nonprice loan terms—maturities, collateral requirements, or even loan sizes. Because of these practices, coupled with the ongoing uncertainty that surrounds future events—specifically, future credit conditions and market interest rates—the prime rate has tended to be more inflexible, or “sticky,” than most other short-term interest rates. As a consequence, most banks have been satisfied simply to follow prime rate adjustments initiated by a few “leader banks.”

Managing bank liabilities

During the late 1940s and throughout the 1950s, large commercial banks were able to accommodate the growth in

The prime rate closely followed other short-term rates in the postwar era



*New series: earlier data not strictly comparable.

Source: Prime rate and rates on CDs, Eurodollars and commercial paper (August 1961–November 1971) from Salomon Brothers. *An Analytical Record of Yields and Yield Spreads*, May 1974.

business loan demand by reducing their large stock of liquid assets—mainly, short-term U.S. Government securities accumulated during the war. Because of the favorable earnings potential of loans vis-a-vis these securities, banks found it advantageous to reduce their U.S. Government security holdings in order to finance more business credit. Because of banks' highly liquid positions, there was little pressure for increases in the prime rate and adjustments occurred only infrequently.

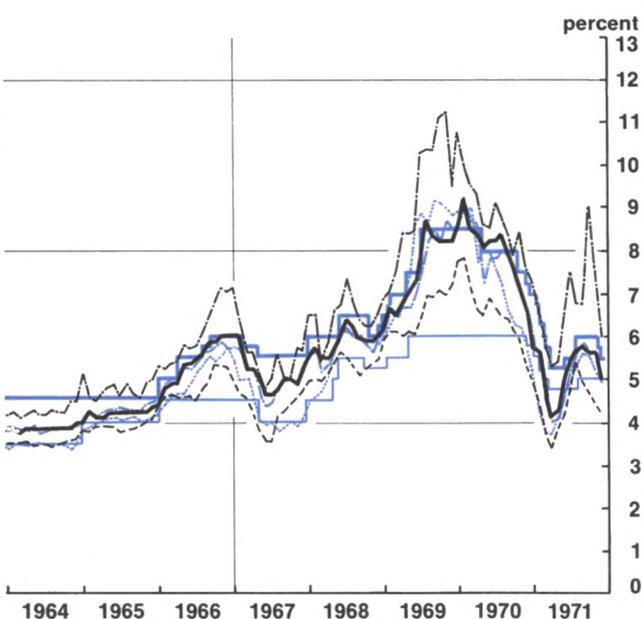
Faced with reduced liquidity in the early 1960s, large banks began to direct more attention to the liability side of their balance sheets. In their competition for funds to meet expanding credit demands, large banks began to rely relatively less on such traditional sources as demand deposits and regular time and savings deposits and to rely more on marginal

sources of funds, including large-denomination negotiable certificates of deposit (CDs), federal funds, and Eurodollars. Negotiable certificates of deposit are bank time deposits with various stated maturities, and federal funds are overnight loans between banks made in immediately available funds. Eurodollars for domestic bank lending mainly are funds acquired by U.S. banks from their foreign branches.

During the 1960-65 period favorable margins between loan returns and costs of market-sensitive funds enabled large commercial banks to meet expanding credit demands while holding the prime rate at 4½ percent. As markets for CDs, federal funds, and Eurodollars matured and competition intensified, however, spreads between the prime rate and rates on bank liabilities narrowed. By December 1965 the Eurodollar rate had risen above the prime rate, and the 90-day CD rate and the federal funds rate had climbed to within less than ½ of 1 percent of the prime.

Beginning in the 1960s, large banks became increasingly sensitive to competition from commercial paper—unsecured promissory notes issued by large corporations either directly or through dealers and sold to large-volume investors, including other large corporations. Competition from the commercial paper market placed unusual pressures on banks in the acquisition and use of funds. During the 1960s the volume of commercial paper outstanding nearly tripled and the number of participants in the market grew considerably. Historically, the prime rate had exceeded the 90-day commercial paper rate by one percentage point or more. This differential narrowed in the early 1960s, as more and more corporations came to view commercial paper as a close substitute for bank credit.

Commercial paper began to compete strongly for investment funds with commercial bank CDs. Top-quality corporate



paper and bank-issued CDs were sold in large denominations and short maturities, and each type of claim carried minimal default risk. Because of these similar characteristics, the same groups of investors—mainly large corporations—constituted the major markets for both commercial paper and CDs. Over time large investors grew increasingly sensitive to interest rate differentials; widening and narrowing spreads between CD and commercial paper rates prompted large quantities of funds to shift between these markets. As a result of this high degree of substitutability, the rate on 90-day commercial paper moved in close harmony with the 90-day CD rate during the 1960s.

In the latter part of the decade banks themselves came to view commercial paper as a ready source of loanable funds. They began to borrow extensively in the paper market by having their affiliates (i.e., holding companies and subsidiaries) issue bank-related paper, and then channel the acquired funds into the bank via loan sales. By December 1969 the volume of bank-related commercial paper outstanding amounted to more than \$4 billion and

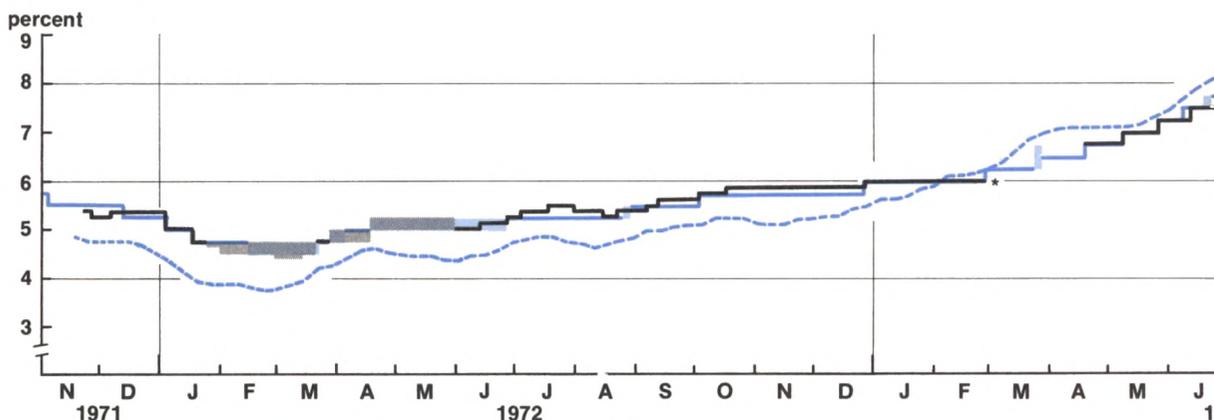
accounted for over 13 percent of the total volume of commercial paper. After reaching \$7.8 billion in July 1970, however, the volume of bank-related paper fell sharply, primarily because of the Federal Reserve's imposition of reserve requirements on this type of paper. By October 1971, when the formula prime was introduced, bank-related paper totaled \$1.9 billion and accounted for less than 6 percent of all commercial paper outstanding.

The formula prime

On October 20, 1971 a few large banks announced that they were considering the feasibility of a formula, or "floating," prime rate—i.e., prime rate quotations adjusted in direct response to variations in the rates on one or more money market instruments. Although the prime rate and market rates always had been related and generally moved together over time, banks had never attempted to explain in detail the connection between them.

The next day, October 21, First National City Bank (Citibank), the largest bank in New York, announced the first

Prime rates could not keep pace with the commercial paper rate, given CID guidelines



Source: Data for November 1971 through July 1973 from Salomon Brothers, *An Analytical Record of Yields and Yield Spreads*, May 1974; other prime rate data from Federal Reserve Bank of Chicago.

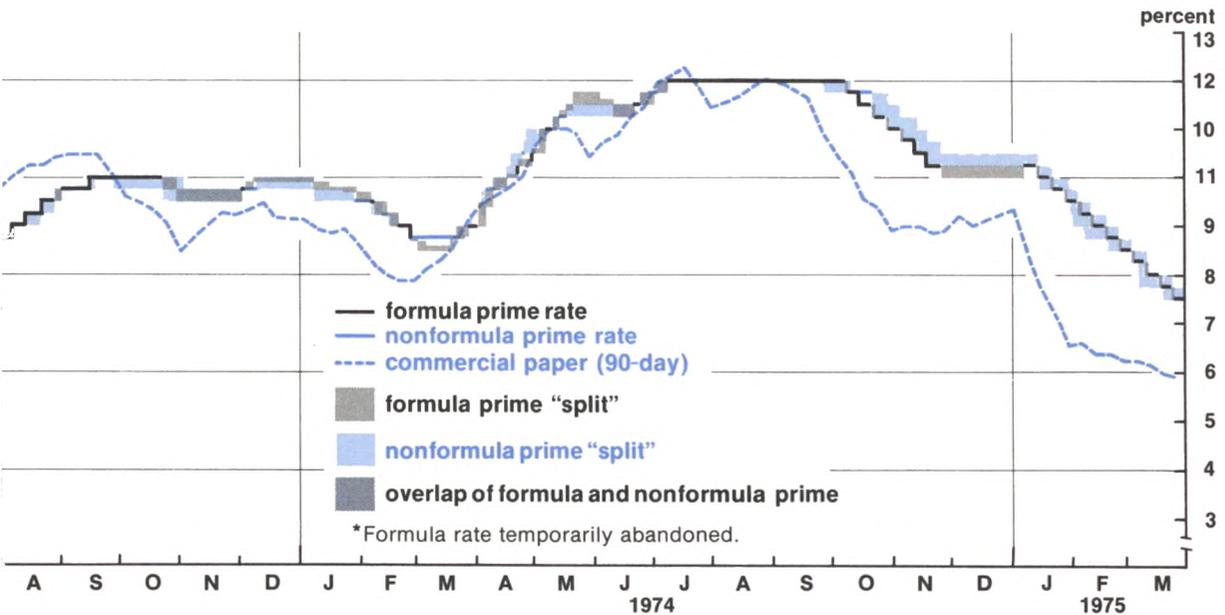
prime rate formula. The essence of the formula was that the prime rate was to be reviewed weekly, adjusted by minimum steps of $\frac{1}{8}$ percentage point, and kept approximately 50 basis points above the average rate on 90-day commercial paper placed through dealers. The choice of the commercial paper rate reflected the high degree of substitutability between bank loans and commercial paper. Moreover, because of its relatively large volume, commercial paper was considered fairly well insulated from unusual disruptive influences on both domestic and foreign credit markets, resulting in a reliable indicator of the "free market rate" for short-term business credit.

By the end of 1971 a few other commercial banks had introduced their own formulas. While differing from Citibank's formula in minor respects, these other formulas followed it in relating prime rate quotations to average rates on top-quality 90-day commercial paper. Banks differed in their choices of which side of the dealer-

placed market to use—the rate charged issuers or the rate offered investors. Some banks chose longer intervals than a week for appraising prime rate adjustments, and some selected $\frac{1}{4}$ percentage point rather than $\frac{1}{8}$ percentage point as the minimum step for prime rate adjustments. One New York bank based its formula rate on two alternative money-market criteria—the issuer rate on 90-day commercial paper (plus .50 of 1 percent) or the 90-day CD rate (plus .65 of 1 percent).

Why a formula prime?

Although its adoption by some of the largest banks was an important event, the idea of a formula, or a "floating," prime rate for business loans was not a new one. Bankers had searched for a long time for some means of insulating prime rate changes from political criticism. And two major political incidents were fresh in the minds of commercial bankers when the formula prime was introduced.



- In December 1964 several banks boosted the prime rate from $4\frac{1}{2}$ to $4\frac{3}{4}$ percent. Although this was the first prime rate movement since August 1960, banks began to rescind their rate hikes two days later, following Presidential urging that rates be held down.
- In June 1969 the prime rate again came under close political scrutiny when banks undertook a full percentage point increase, from $7\frac{1}{2}$ to $8\frac{1}{2}$ percent, at that time a record high. This move kindled immediate Congressional response, and ten days later hearings were convened by the House Committee on Banking and Currency for the specific purpose of investigating prime rate increases. On this occasion, however, banks did not rescind their increases, and the $8\frac{1}{2}$ percent rate remained in effect until March 1970 when it was lowered to 8 percent.

In the fall of 1971 signs pointed toward a renewed round of political concern. Phase I of the wage-price control program had been unveiled two months earlier and Phase II was due in about a month. The Committee on Interest and Dividends (CID), organized under the Economic Stabilization Program, had taken initial steps to monitor interest rate developments. On October 20, 1971, just one day before Citibank announced its formula rate, the CID requested that all lending institutions keep records of their loan rate schedules, retroactive to August 15, 1971. This CID action suggested to commercial banks that closer scrutiny of prime rate revisions might be approaching.

How precise were the “formulas”?

The nonformula prime rate had been moving steadily downward for several weeks prior to introduction of the formula rate. Soon after the formula rate was inaugurated, it, too, began to follow a declining pattern, falling from 5% percent in

November 1971 to a low in March 1972 of $4\frac{3}{8}$ percent—the lowest level in over a decade.

Beginning in April 1972, the formula rate reversed direction and began to move steadily upward. By early October 1972 it had climbed to $5\frac{3}{4}$ percent—the level that prevailed just prior to the introduction of the formula concept one year earlier. On October 12, 1972 the Committee on Interest and Dividends released a statement expressing concern over prime rate developments and giving notice that it would review the earnings of financial institutions in the course of monitoring interest rate movements. Nevertheless, the formula prime continued to rise, moving from $5\frac{3}{4}$ to $5\frac{7}{8}$ percent in mid-October and then to 6 percent late in December.

The rate remained at 6 percent during January 1973 as the conflict between CID objectives and formula rates—tied to a sharply rising 90-day commercial paper rate—began to intensify. On February 2 four banks announced increases in their prime rates from 6 to $6\frac{1}{4}$ percent. On February 4 the CID requested that the banks justify the increases by supplying information on operating costs and earnings. Shortly thereafter, the four banks rescinded their increases.

This incident was followed by a CID statement, released on February 23, outlining acceptable conditions for prime rate increases: (1) they should be much smaller than changes in “related open market interest rates,” (2) they should be delayed to assure that open market increases are not temporary, and (3) they should not prompt large increases in rates on small business loans. Considering that the commercial paper rate was rising rapidly during this period, the first two of these conditions undermined the floating rate concept as defined at that time. As a result, floating prime rates were abandoned industry-wide near the end of February 1973.

On April 16 a set of 14 CID guidelines

The dual prime

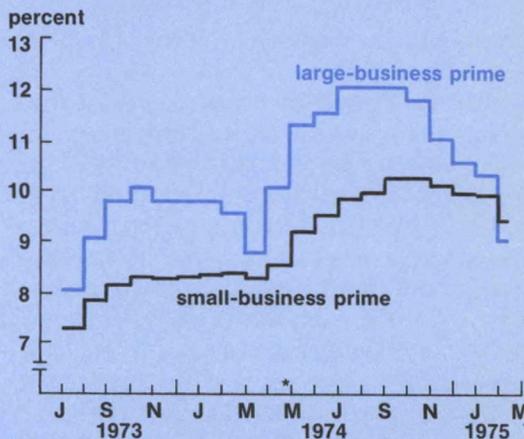
Included in the Committee on Interest and Dividends (CID) guidelines of April 16, 1973 were instructions for commercial banks to establish a "dual prime" system. The dual prime was to consist of a "large-business prime rate" (the conventional prime rate) and a "small-business prime rate" applicable to a commercial bank's least risky local borrowers. Banks were expected to show special restraint in raising the small-business prime, increases being deemed justifiable only when rising costs of funds were not offset by increasing revenues from large-borrower loans and other loans and investments. As a consequence, the small-business prime was expected to change less frequently and in smaller steps than the large-business rate.

The CID defined a "small business" as any domestic business establishment (including farms) with (1) total indebtedness, excluding long-term real estate debt, of \$350,000 or less for the preceding 12-month period, and (2) total assets of not more than \$1 million. As long as a particular loan did not place a business firm over the \$350,000 debt limit, qualifications for the small-business prime were independent of the dollar amount of individual loans.

Monthly data on the small-business prime indicate that the major objective of the dual rate structure was achieved: the small-business prime increased much more gradually than its large-business counterpart. Greater risks and higher per-dollar costs of lending to smaller firms suggested that the small-

business prime would exceed the large-business rate. When the dual rate was initiated in April 1973, however, many banks pegged the small-business prime at or near the level of their regular prime quotations, 6½ percent. As a result of relatively steeper increases in the large-business prime in subsequent months, the large-borrower rate soon surpassed the small-borrower rate and has remained above it until recently. Some banks have continued reporting a small-business prime even though the CID was dismantled on April 30, 1974.

Unexpectedly, the small-business prime remained below the large-business rate until recently



*Small-business prime rate loses its official status.

Note: The small-business prime rate is the simple unweighted average of the rates in effect on the last business day of the first full calendar week of the month at 370 commercial banks; the range of variation of these rates is considerable. The large-business prime rate is the rate most commonly quoted by large banks on that date.

for commercial bank loan rates became effective. Included were provisions for commercial banks to establish a "dual prime" system consisting of a "large-business prime rate" and a "small-

business prime rate." The CID guidelines permitted commercial banks to adjust their "large-borrower prime rate" (the conventional prime rate) in accordance with "... costs of borrowing from alternative

market sources. . . .” This particular guideline was fundamental to formula rate calculations and permitted the reinstatement of the formula concept.

On April 19 Citibank announced that it would return to a formula rate. Although its formula called for a $7\frac{1}{2}$ percent prime, Citibank did not adhere to its formula. Citibank’s actual prime rate was revised from $6\frac{1}{2}$ to $6\frac{3}{4}$ percent on April 19—the same rate initiated a day earlier by nonformula banks. Although other banks expressed some interest in returning to formulas, the First National Bank of Chicago was the only other large bank to endorse the concept. The formula announced by the Chicago-based bank on May 7 set the prime at 1.08 times (i.e., 108 percent) the three-week average rate on 90-day commercial paper. The Chicago bank posted an initial rate of 7 percent, despite the fact that its new formula called for a rate in the $7\frac{1}{2}$ to $7\frac{3}{4}$ percent range.

In subsequent months, as the prime continued to rise, the two formula-prime banks posted rates from $\frac{1}{2}$ to $\frac{3}{4}$ of a percentage point below their formula-derived rates. Although these banks were anxious to reconcile actual rates with the floating concept, the sensitive political situation prevented them from doing so in the face of steady increases in the rate on 90-day commercial paper. Both banks had started the CID-guideline period with prime rates well below their formula rates. The CID guidelines of April 16 called for increases in the rate to be taken in “moderate steps,” and the CID had requested that rate increases be undertaken with relative infrequency. Compliance with these guidelines effectively precluded the formula-rate banks from fully implementing their formulas in the face of a rapidly rising commercial paper rate.

The paper rate began falling in late September for the first time in 1973, and formula banks were finally in a position to adjust actual rates to their formulas. In the

fourth quarter of 1973 the commercial paper rate dropped below both the nonformula and formula prime rates for the first time since the first quarter of that year, and formula relationships were reestablished.

When the prime rate was increased to 10 percent in mid-September 1973, financial observers suggested that, mainly because of political considerations, an upper limit had been reached. This view gained support when large banks, after lowering their prime rates slightly in the fourth quarter of 1973, closed out the year with rate quotations at or near (but not above) the 10 percent mark.

The idea of a “ceiling” on the prime rate, however, was short-lived. Although the prime fell as low as $8\frac{1}{2}$ percent at some banks during the first quarter of 1974, by mid-April the rate was again at 10 percent and a few banks already had moved to quotations above 10 percent. Subsequently, over a dozen record-breaking highs were recorded and, by mid-July 1974, most commercial banks were posting a 12 percent prime rate. In the weeks after the 12 percent prime rate was initiated, floating-rate banks again began holding their posted rates below the rates called for by their formulas. At times during the almost three-month reign of the 12 percent prime, formula-rate calculations were one-half of a percentage point or more above the posted rate.

Since late September 1974, the prime rate declined from its 12 percent high and stood at less than 8 percent in late March 1975. Both First National City Bank and The First National Bank of Chicago have announced that, while not abandoning the formula concept, they would use it as an indicator of the direction of prime rate changes rather than as a precision instrument. As a result, posted rates have declined at these banks but not as rapidly as the formula-based figures.

Randall C. Merris

Bank holding companies - Part II

Under the Bank Holding Company Act of 1956 the Board of Governors may not approve a holding company acquisition that *may* substantially lessen competition unless the anticompetitive effects are clearly outweighed by such factors as the convenience and needs of the community or financial and managerial considerations.

Many of the Board's early denials of bank holding company applications were based on *existing competition*; that is, a holding company was seeking to acquire a bank with which one of its subsidiaries was in direct competition. Because of the difficulty of gaining Board approval to acquire a direct competitor, many holding companies found it necessary to acquire banks in cities far removed from the markets served by their subsidiary banks. However, an acquisition which eliminates no existing competition may be *potentially* anticompetitive if it would foreclose the possibility that the holding company's subsidiary banks and the bank to be acquired might compete in the reasonably foreseeable future.

The potential competition concept

The concept of potential competition is concerned with the possible anticompetitive consequences that could flow from the combining of two business enterprises which do not compete with one another because they do business in separate geographic or product markets.

The Board has applied the term "potential competition" to at least four situations. In its purest sense the concept posits that the *conduct* of established sellers in a market may be influenced by the existence of one or more likely potential entrants. But because of the difficulty of

proving that a bank holding company located in New York City can influence the pricing and services of a bank in, say, Buffalo, the concept of potential competition did not win widespread acceptance until very recently.

The Board has applied the term "probable future competition" (sometimes interchangeably with the term "potential competition") to situations where, in its judgment, an alternative means of entry might be more conducive to increasing competition. That is, it would be preferable from the standpoint of the public if a holding company entered a market by establishing a new firm (de novo entry) or acquired a small firm already in the market (a so-called "foothold acquisition") rather than acquiring one of the leading firms in that market. Both de novo and foothold entry add to the number of firms offering significant competition to the leading firms in a market and may be expected to lessen future levels of market concentration. Thus, implicit in the Board's use of the term "probable future competition" is the *expectation* of procompetitive effects following actual de novo or foothold entry by the applicant holding company.¹

Recently, the Board has broadened the concept of potential competition to reflect its concern with two other situations. One is the case where a holding company seeks to acquire a fairly sizable bank outside the holding company's market, thereby foreclosing the possibility that the bank could ever form its own holding company and ex-

¹The distinction between potential competition and probable future competition has been provided by Stephen A. Rhoades. See "Some Observations on Potential Competition in Banking," in *Proceedings of a Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, 1972. In this article potential competition is used to refer to both concepts.

pand into the market(s) of the acquiring holding company. The other concerns the situation of a holding company acquiring two banks in the same market that have some affiliation with one another. This type of acquisition not only forecloses the possibility of the two banks competing in the future, but also the possibility that one of them might be acquired by a banking organization not presently in the market.

Analysis of Board denials

The Board's negative attitude toward situations involving potential competition is by no means new; indeed, potential competition was first cited as an important factor in denying a holding company application in 1960. Since that time, the Board has used potential competition more and more

Analysis of potential competition denial orders

	Denials of holding company applications ¹	Denials involving potential competition	
		Major factor ²	Minor factor ³
1957-66	26	0	11
1967-70	17	8	3
1971	10(1) ⁴	3(1)	4(0)
1972	28(9)	4(1)	7(4)
1973	26(10)	7(2)	10(3)
1974	43(10)	11(3)	8(2)
	150(30)	33(7)	43(9)

¹Includes only denials of applications: to acquire banks under Sections 3(a)(1), 3(a)(3), and 3(a)(5) of the Bank Holding Company Act; and to acquire nonbank companies under Section 4(c)(8) during the 1971-74 period.

²Means potential competition alone was sufficient to outweigh factors favoring approval. In such cases existing competition was insignificant.

³Means potential competition, though an important factor favoring denial, could not by itself sustain a denial recommendation.

⁴The numbers in parentheses represent denials of nonbank acquisitions under Section 4(c)(8). Prior to 1971, all denials shown in the table involved acquisition of banks. The number to the left of the parentheses includes the 4(c)(8) denials.

frequently as a factor in disapproving holding company applications.

To gain a better understanding of the evolving use of the potential competition concept as it relates to the Board's administration of the Bank Holding Company Act, all Board denial orders issued under the act during the 1957-74 period were analyzed. The analysis reveals that in these 18 years, the Board issued a total of 150 denial orders. Of these, more than half (76) cited potential competition as either a major or minor factor in the decision to deny the applications. Further, of the 76 denial orders involving potential competition, almost half (36) were issued in 1973 and 1974.

From 1957 through 1965 only ten denials of holding company applications involved potential competition; in none of these was the concept a major issue. Not until April 1967 was a holding company application denied primarily on potential competition grounds.²

On a relative frequency basis potential competition was far more important as a cause for denials in the 1967-70 period than at any time before or since. From 1967 through 1970, 65 percent of all denial orders involved potential competition, and in 47 percent of these potential competition alone was sufficient cause for denial. In the previous ten years (1957-66) potential competition played only a minor role in 42 percent of all Board denial orders. In 1973 and 1974 the Board issued 69 denial orders and 52 percent of these (36) involved potential competition; however, potential competition was the *major* factor in only 26 percent of these denials.

Why the change?

There are several reasons for the recent increase in the number of denials involving potential competition. Possibly

²In 1962 the Board denied a bank *merger* primarily on the basis of potential competition.

the most important reason is the increased number of applications from holding companies in states where multibank holding companies have been particularly active in acquiring banks. As holding companies have exhausted the expansion possibilities in their own markets, they have had to resort to the acquisition of banks located in markets progressively more distant from their subsidiary banks. Attempts by one of a state's larger holding companies to acquire leading banks in distant markets are likely to be denied on the basis of potential competition. This is particularly likely if the markets are highly concentrated.

Another reason for more Board denials based on potential competition is the increased activity of bank holding companies in acquisitions of nonbank businesses as a result of the 1970 amendments to the act. Most of these involved applications to acquire consumer finance and mortgage banking companies, two activities that many holding companies are well-equipped to enter *de novo*. Attempts to acquire leading firms in these industries, particularly where there was geographic (but not product) market overlap between the nonbank company and the holding company's subsidiary bank(s), have been struck down by the Board because of the adverse effects such acquisitions would have on potential competition.

The reasons for the recent decline in the percentage of denials involving potential competition are twofold. First, the capital adequacy of banks and bank holding companies became an increasingly prevalent reason for denying applications (see *Business Conditions*, February 1975). In the 1973-74 period capital adequacy was an adverse element in almost 33 percent of Board denials compared to less than 6 percent in the 1967-70 period and 24 percent in 1971-72. Second, as the record on denials has developed, holding companies have gained insights into Board attitudes toward the evolution of the financial struc-

tures within their states. One or more denials on grounds of potential competition usually suffice to give holding companies a clear idea of the type of acquisition that is likely to be denied. As acquisitions with little likelihood of approval are eschewed, the Board's denial rate falls.

Judicial precedents

Between 1967 and 1974, the Board denied 33 bank holding company applications primarily on the basis of potential competition. During all but six months of this period judicial attitudes toward the application of the potential competition concept to banking were in doubt.³ The potential competition concept as applied to banking was first given credence in the U.S. Supreme Court decision in *United States v. Marine Bancorporation* on June 26, 1974.⁴ Although ruling against the Justice Department with respect to the specific case, the Court upheld the Justice Department's use of potential competition with the proviso that "the application of the doctrine to commercial banking must take into account the extensive and unique federal and state regulatory restraints on entry into that line of commerce . . ."

In view of its denial record dating back to 1962, the Board was 12 years ahead of the courts in applying the concept of potential competition to banking. These denials arrested or considerably slowed, in its incipency, a trend toward increased concentration in banking which had been emerging in many states.

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³The U.S. Department of Justice had repeatedly been frustrated in attempts to block bank mergers involving potential competition, having lost eight District Court cases between 1967 and 1973.

⁴The legal precedent for denying acquisitions of *nonbank* companies on potential competition grounds was clearer. See *FTC v. Proctor & Gamble*, 386 U.S. 568 (1967), and *United States v. Continental Can Co.*, 378 U.S. 441 (1964).

