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The credit restraint program in perspective

The history of potential competition in bank mergers and acquisitions

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Utilizing the bank holding company

Excerpts from a speech by Mr. Robert P. Mayo, President, Federal Reserve Bank of Chicago to the 41st Assembly for Bank Directors, Southhampton Princess, Bermuda, May 26, 1980

The use of the bank holding company as an organizational form for owning and controlling commercial banks is neither a new device nor a recent one. In fact, it dates back to around 1900. At that time, the bank holding company provided a device for owning several banks at a time when branching was prohibited, or severely limited, in every state. To this day, restrictive branching laws have remained one of the primary reasons for embracing the holding company organizational form as banks have sought to approach the geographic mobility of their customers. Multibank holding companies tend to be most important in those states with highly restrictive branching laws and to be relatively unimportant in those states that allow statewide branching. In states that prohibit multibank holding companies, chain or group banking has flourished. What distinguishes bank holding companies from chain banking organizations is the fact that bank holding companies are formally organized and are generally chartered as corporations.

Bank holding companies have been organized to get around not only state branching restrictions but other types of banking regulation as well. One of the more common reasons for forming bank holding companies was to engage in activities that banks were prohibited from performing themselves, or to engage in a permissible activity (like lending) at a geographic location where a particular bank subsidiary was not allowed to operate.

Holding company flexibility takes other forms as well. The parent bank holding company, like any other kind of holding company, is able to exploit a very useful accounting device. The holding company can downstream funds raised in the debt market to its bank subsidiary, on whose balance sheet they appear as common stock or equity. This seemingly magical transformation from debt to equity has been accorded the loaded label of "double leveraging." While not unique to banking, it is another example of the flexibility of the holding company mechanism as a device for circumventing certain regulatory barriers.

The bank holding company form of organization declined in importance during the 1930s and early 1940s, thus minimizing the need for additional regulation, particularly with regard to the formation and expansion of holding companies. But a major merger movement began following World War II. Existing bank holding companies began to increase the number of banks they controlled. A few of these holding companies operated banks in several states. In addition, some bank holding companies were being used as a corporate device to engage in business activities unrelated to banking, thus evading the intent of the Banking Act of 1933 which, among other things, sought to separate banking from other lines of commerce.

Regulating bank holding companies

Comprehensive federal regulation of bank holding companies was not enacted until 1956. The main thrust of the Bank Holding Company Act of 1956 was that it formally recognized the bank holding company, despite some abuses that had taken place in the past, as a legitimate form of banking organization, the formation and expansion of which may be in the public interest if properly regulated and controlled.

Congress had three primary concerns with bank holding companies that it felt could be dealt with most effectively by regulation. First, there was the fear of economic

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concentration, and the social and political overtones associated with it. The increased number of banks affiliated with bank holding companies, while certainly not posing a monopoly problem nationally—there were still more than 13,000 insured commercial banks in operation in 1956—did, nevertheless, give rise to concern about increased concentration of financial resources at the state and local level. Congress tried to nip this trend in the bud by applying the antitrust laws to bank holding company expansion.

A second concern of Congress was the potential for unsound banking practices facilitated by the holding company form of orgaization. Because of this concern, Congress directed the Federal Reserve Board to consider financial and managerial criteria in determining whether to approve or deny an application by a multibank holding company to acquire an additional bank. Congress's last major concern, addressed in the Bank Holding Company Act, was that a holding company's nonbanking activities should be strictly circumscribed, being merely "a proper incident to" banking and limited to activities of a "financial, fiduciary, or insurance nature."

Companies that controlled only one bank were not covered by the 1956 legislation. In part this was because there weren't very many of them; their control was primarily limited to small banks; and there were few, if any, abuses or circumventions of regulation by these companies. Following the credit squeeze of 1966, many bankers began to realize that a holding company might provide improved access to the money and capital markets, in particular, to the commercial paper market where there were no interest rate ceilings to contend with. As a result, many of the nation's largest banks began to organize holding companies to achieve the financial flexibility they deemed necessary to deal with the next credit squeeze. Many of these one-bank holding companies also took advantage of their unregulated status by performing nonbanking activities that were prohibited to their bank subsidiaries or performing bank-like activities at locations where their banks were not allowed to operate. Congressional concern with performance of these nonbank activities, particularly those that clearly broke with this nation's tradition of arm's length dealings between a bank and its customers, resulted in closing the one-bank loophole in 1970.

Current Federal Reserve emphasis

There are many benefits to a bank holding company, but most of these are *private* benefits that accrue to the owners of the holding company. To some extent, of course, these benefits may trickle down to a holding company's customers and translate into benefits to the general public. The focus of the Bank Holding Company Act is on *net benefits to the public* that outweigh any possible adverse effects such as unsound banking practices, conflicts of interest, undue concentration of resources, and anticompetitive effects. Thus, the Federal Reserve is charged by law with examining the impact of holding companies on bank customers.

The benefits of a bank holding company to stockholders are numerous. Among these benefits are tax deferral and tax avoidance, financial leverage, improved access to capital markets, and the ability to expand product and geographic markets. The last two of these private advantages also improve the ability of a bank to serve the convenience and needs of the public—one of the factors that the Federal Reserve must take into consideration in weighing all applications.

In deciding on the merits of an application, the Fed must focus first on the competitive effects of a holding company formation or bank acquisition. If anticompetitive effects are found, then enhanced convenience and needs or improved managerial or financial factors can be given weight. In practice, however, serious anticompetitive effects have never been outweighed by these other considerations except where the acquired bank was on the brink of failure. Where the anticompetitive effects are only slight, these effects can be, and sometimes are, outweighed by enhanced convenience and needs

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or financial factors—for example, by the provision of new or additional services, a commitment to increase interest rates to Regulation Q ceilings, or an injection of equity capital into one of the holding company's banks.

Regardless of whether there are anticompetitive effects, the Board must examine, in every application, convenience and needs and financial factors. The Board, by denying dozens of applications on these grounds, has voiced its concern about the use of the holding company device as a means of increasing financial leverage and achieving tax avoidance at the expense of the potential safety and soundness of the subsidiary bank. The Board's legal authority to concern itself with the capitalization of affiliated banks over which it has no direct supervisory authority was upheld by the U.S. Supreme Court in the 1978 *First Lincolnwood* decision.[1]

Filing an application

An application to form or expand a bank holding company must make a compelling case that the public will benefit as a result of the proposal. It is, of course, a foregone conclusion that the holding company and its owners will benefit—or else why would the transaction be undertaken in the first place? It is the responsibility of the Federal Reserve to ensure that a holding company does not benefit at the expense of the nonbank public. In order to carry out this responsibility and to satisfy the legal requirement of a complete public record, the Fed requires that a standard application be submitted for prior approval—in multiple form, since copies must go to the Board, the Reserve Bank, other appropriate bank regulators, and the Justice Department.

Each application has several sections that deal with a description of the transaction and its competitive, financial, and convenience and needs implications. More recently, several questions have been added to ascertain the applicant's compliance with the spirit and intent of the Community Reinvestment Act. Rarely is an application submitted that contains fewer than 50 pages; the majority of applications contain at least 75 pages; and it is not unusual for applications involving complex transactions to total more than 200 pages. To a considerable extent, this one-time reporting burden is mandated by the requirement that an application be "legally sufficient and informationally adequate." This could be more simply expressed as the need for an application to contain all information a reasonable person would find necessary to decide whether it should be approved or denied. The time involved in processing an application has generally been reduced when the applicant has assumed a large burden of the proof by making certain that the application supports, with facts, any promises of public benefits.

Costs and benefits

The Federal Reserve System has been very much concerned with both on-going and one-time reporting burdens on banks and bank holding companies. Nevertheless, filing a bank holding company application is not inexpensive. Research done at the Chicago Fed has shown that, on average, an application to form a one-bank holding company would cost the applicant approximately $15,000.[2] It would cost almost that much for an existing holding company to apply to acquire another bank. In addition, holding companies must file an annual report with the Fed, typically costing at least $1,000 and for the larger, active, or complex holding companies, around $3,000-$5,000. Companies with assets exceeding $300 million have additional reporting requirements, as well as more frequent—generally annual—inspections by a Federal Reserve team to assure compliance with the bank holding company laws and to assess the overall financial condition of the

[1] *Board of Governors of the Federal Reserve System v. First Lincolnwood Corporation,* 439 U.S. 234 (1978).

[2] Harvey Rosenblum, "A Cost-Benefit Analysis of the Bank Holding Company Act of 1956," in *Proceedings of a Conference on Bank Structure and Competition,* Federal Reserve Bank of Chicago, 1978, pp. 61-98.

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company. Bank holding companies with more than 500 stockholders must also file reports with the Securities and Exchange Commission, so they can expect the costs just mentioned to increase some three or fourfold. The combined costs to the holding companies and to the Federal Reserve System of complying with requirements of the Bank Holding Company Act are not trivial. For 1978, the last year for which complete data are available, they have been estimated to be running around $30 million per year, about equally divided between the holding companies and the Federal Reserve.

What has been gained by an expenditure of resources of this magnitude? How is the public better off as a result of this compliance and enforcement burden? Although policymakers within the Federal Reserve have been deeply concerned with these questions, the best available research shows that enforcement of the Bank Holding Company Act has generated benefits to the public that have exceeded its costs. For example, the Board has denied dozens of applications that would have eliminated competition between two banks in the same market. The benefits to bank customers in the form of lower-priced bank services, just from denials of applications that would have eliminated existing competition, have been more than sufficient to outweigh all other costs associated with the act.[3]

The Board has also been concerned by holding company acquisitions of leading banks in markets that could be entered by more procompetitive means, such as by chartering a de novo bank or by acquiring one of the smaller banks in the market. The Board has denied several such potential competition cases in the last six months. The Board has not limited its concern about anticompetitive effects to multibank holding companies; in May 1977, it began to treat chain banking organizations as de facto multibank holding companies and has denied the private benefits of the holding company organizational form to one-bank holding companies whose existence would further an anticompetitive arrangement. Public benefits have also been generated by the Board's insistence that when competitive effects are slightly adverse, the holding company must make some commitment to provide services or alter prices charged by the acquired bank so that the public will be better off from the acquisition. The Fed follows up to see that those commitments are met.

Finally, the Board must evaluate the impact of the holding company on the safety and soundness of its subsidiary bank(s). The Board's main concern in this area has been with the use of excessive debt at the holding company level and the consequent strains on the bank affiliate to help in servicing that debt, year-in and year-out, in good times and bad. While the Board has recently relaxed its debt standards somewhat for small one-bank holding companies, it has in no way relaxed its commitment to maintain the safety and soundness of affiliate banks. The Board will continue to look askance at holding company proposals that may entail difficulties in debt-servicing, particularly if they would be likely to lead to impairment of the capital accounts of the bank subsidiary.

As with most regulations, the costs of the Bank Holding Company Act are imposed upon all those who must comply, not just on those few whose abuses gave rise to the need for regulation in the first place. But, unlike many other laws and regulations on the books, it appears that for the Bank Holding Company Act, the benefits of regulation outweigh the costs. Furthermore, the costs imposed by holding company regulation have not been sufficient to outweigh or stifle the creativity and advantages stemming from the bank holding company organizational form.

The holding company offers financial, product, and geographical flexibility that is beyond the reach of an individual bank. The holding company movement's continued vitality demonstrates that the Federal Reserve has allowed this flexibility to work to the public's good.

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[3]Ibid.

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The credit restraint program in perspective

Randall C. Merris and Larry R. Mote

The anti-inflation program the President announced on March 14 included—along with promises of cuts in federal spending for the rest of this fiscal year and a balanced budget for the year beginning in October—a set of selective policy measures designed by the Federal Reserve to restrain credit growth.

Parts of the Federal Reserve program were implemented under the Credit Control Act of 1969, which the President invoked for the first time. The act empowers the President to authorize the Federal Reserve Board "to prohibit or limit any extensions of credit under any circumstances the Board deems appropriate." Such broad powers could be used to impose far-reaching controls on banks and other financial institutions and, in fact, on all private and public credit markets.

Under the new program, however, the Board chose to implement credit restraints only in a selected set of private credit markets and, within the markets directly affected, in a somewhat flexible way. The limited scope of the program reflected the Board's intention that the credit restraints supplement, not supplant, the restrictive fiscal and monetary policies that the Administration and the Federal Reserve had announced they would pursue. The program was designed partly to reinforce these general economic policies and partly to mitigate their most serious side effects.

The program

One of the most important actions taken by the Board on March 14 was the establishment of a voluntary Special Credit Restraint Program applicable to banks, bank holding companies, and finance companies. Several provisions of the Special Credit Restraint Program were addressed specifically to banks. They were advised to hold loan growth within the 6 to 9 percent range previously targeted for total bank credit by the Federal Reserve. Banks were also encouraged to restrain certain types of lending considered nonproductive, inflationary, or of low social priority. Included were unsecured consumer lending, financing of corporate takeovers or mergers, and financing of purely speculative holdings of commodities. Banks were also asked to restrain the growth in commitments for backup lines to support commercial paper borrowing. They were strongly urged to maintain the availability of funds to small business, farmers, and homebuyers.

The Special Credit Restraint Program originally called for monthly reports on lending activity at large domestic banks, bank holding companies, and U.S. agencies and branches of foreign banks. Monthly reports were also requested on commercial paper issues and overseas borrowing of a panel of large corporations and on business credit outstanding at large finance companies. Quarterly reports on lending were required from intermediate-sized banks ($300 million to $1 billion in total assets). Smaller banks were exempted from reporting under this program.

Reporting burdens were reduced on May 22 when the Board announced that lending institutions previously scheduled to report monthly would henceforth report bimonthly. At the same time, the first quarterly report for intermediate-sized banks, due in June, was simplified. The need for subsequent reports from these banks was to be evaluated by the Board after the first set was received. The Board also discontinued the reporting requirement for the panel of large corporate borrowers.

Another important action taken by the Board was the imposition of a 15 percent spe-

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cial deposit requirement on increases in consumer credit. This requirement was, in essence, the first application of asset-based reserve requirements in the United States. The idea of applying reserve requirements to specific categories of asset holdings, rather than deposits, originated during the early 1950s and has been widely discussed ever since.[1]

Special deposit requirements on increases in consumer credit were adopted in the belief that consumer spending, a sizable part of which has been financed by an unprecedented expansion in consumer borrowing in recent years, has been a major contributor to the inflationary spiral. Mortgage credit, automobile loans, and other forms of secured credit involving purchase of the security with the proceeds of the loans were exempted from the special deposit requirement because of the depressed state of the housing and automobile industries.

A 15 percent special deposit requirement on increases in total assets of money market mutual funds was also instituted on March 14. This requirement, however, is conceptually different from the asset-based special deposit requirement against consumer loans. Because the deposit requirement on money market funds applies to increases in any and all of their assets, it does not represent an attempt to direct credit away from (or into) any specific uses.[2] In fact, no substantive difference would have resulted if the special deposit requirement had been applied to increases in the amount of money invested in these funds—that is, the net purchases of new shares of money market funds—rather than to increases in the assets of these funds.

Similarly, the other major actions taken by the Board on March 14 were aimed at increasing the costs of lending by banks and other financial institutions, rather than at selectively encouraging or discouraging particular types of loans. These actions included an increase from 8 percent to 10 percent in the marginal reserve requirements against the managed liabilities of large member banks—such as large short-term time deposits, borrowings from foreign branches, repurchase agreements, and federal funds purchases from nonmember institutions. At the same time, the base amount of these liabilities that would be free of reserve requirements was reduced from the level set when the requirements were introduced in October 1979. A 10 percent special deposit requirement on increases in managed liabilities of large nonmember banks was also included in the Board's March 14 actions. A 3 percent surcharge on member bank borrowing from the Federal Reserve was introduced temporarily but was discontinued in early May.

On May 22 the Board announced reductions from 10 percent to 5 percent in the marginal reserve requirement on managed liabilities of member banks and in the special deposit requirement on such liabilities at nonmember banks, together with an upward adjustment in the requirement-free base. Responding to the slowdown in credit-financed consumer spending, the Board also halved the special deposit requirement against covered types of consumer credit; both this requirement and the special deposit require-

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[1]For example, see *Monetary Policy and the Management of the Public Debt,* S. Doc. 123, Pt. 1, 82d Cong. 2d Sess. (Government Printing Office, 1952), pp. 484-88; and Samuel B. Chase, Jr., "Use of Supplementary Reserve Requirements and Reserve Credits to Even Out the Flow of Mortgage Funds," in *Ways to Moderate Fluctuations in Housing Construction* (Board of Governors of the Federal Reserve System, 1972), pp. 97-109.

Other countries have made extensive use of selective credit restrictions, including in some cases asset-based reserve requirements. In reviewing the experience of these countries, it is important to keep in mind that they differ widely from the United States both in terms of their financial systems and their instruments and techniques of monetary and fiscal policy. For an analysis of selective credit controls overseas, see Donald R. Hodgman, *Selective Credit Controls in Western Europe* (Association of Reserve City Bankers, 1976).

[2]An exception was those money market funds that invest at least 80 percent of their assets in short-term tax-exempt obligations. Tax-exempt holdings of such funds were exempted from the special deposit requirement. To this extent, the special deposit requirement on assets of money market funds contained a selective element.

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ment on increases in assets of money market funds were lowered from 15 percent to 7½ percent.

Lessons from experience

The program was designed to cope with problems very much in evidence in previous periods of credit stringency, notably 1966, 1969, and 1973-74. In each of these periods, interest rates rose to new post-World War II highs and such interest-rate sensitive sectors as homebuilding, small business, and state and local governments were severely squeezed. This was in contrast to the growth in credit to finance business spending, including mergers and takeovers, which continued to grow until well into the recessions that followed the periods of tight credit. More and more frequently in recent years, these temporary imbalances in the economy have been seen as involving heavy social costs, as for example, the cyclical underutilization of resources in the homebuilding industry, increases in the rates of failure by small businesses, and the postponement of projects by state and local governments.

At the same time, there has also been a widespread notion that the traditional tools of fiscal and monetary policy either are inadequate or have not been used with sufficient vigor to restrain the growth of credit during business expansions—in either case, they have not succeeded in controlling inflation. It has become fashionable to observe that as high interest rates have not held down business borrowing, it is necessary to use more direct means to limit the availability of credit and restrain growth in aggregate demand. It has even been suggested that as interest is an element of business costs, high interest rates are counter-productive in the fight against inflation. They simply translate into higher commodity prices.

The purposes of the credit restraint program in an inflationary environment were to reinforce the Federal Reserve's efforts, through its pursuit of a reserve target, to slow the growth of money and credit and to mitigate some of the more painful dislocations that usually come with tight credit. To the extent that the program has succeeded in slowing the growth of consumer and total credit—and there is considerable evidence that it has—while maintaining to some extent the flow of credit to agriculture, housing, small business, and municipal finance—here the evidence is less convincing—it has done its job.

The program may also have had the salutary effect of lowering the public's expectations of future increases in prices—thereby hastening the adjustment to a slower rate of expansion of demand and reducing the severity of the impact on employment and output. If so, it has done all one could reasonably hope for. But any permanent lowering of the public's expectations for price developments will depend on the steadfastness with which restrictive monetary and fiscal policies are pursued over the coming year.

To evaluate the credit restraint program properly, it is necessary to keep in mind its goals and the difficulties that would be likely to accompany any effort to broaden its scope or purposes. The program was designed to limit the cyclical variation in the supply of credit for housing, agriculture, and small business, not to increase the share of credit going to these sectors over the long run. It was not intended to remain in effect beyond the period of difficulty that gave rise to it.

Accepting for purposes of discussion the validity of the arguments for increasing the share of resources going to certain sectors, the program is not well suited to the pursuit of such long-term goals. Because of the broad categories it established, its basically voluntary character, and the fact that it has left all individual credit decisions to the private lending institutions, the program could more accurately be described as a call for cooperation than a system of rigid controls. In what was widely regarded as a short-term quasi-emergency, the cooperation the program relies on was forthcoming. But in the long run, the program would be unlikely to be effective in the face of contrary forces affect-

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ing the profits of participating institutions. In blunt terms, a dollar loaned to a large business may be more profitable than a dollar loaned to a family buying a house.

Experience with mandatory credit controls on consumer credit during World War II and on both consumer and mortgage credit during the Korean War showed that controls become progressively less effective the longer they are in force. Lenders find ways to circumvent regulations. Reflecting its fungible nature, credit extended for one purpose is actually used for another. When controls are in force long enough, new institutions arise to service demands left unmet by regulated institutions. To keep up with such developments, regulation must be constantly expanded in detail and institutional coverage. Otherwise, it gradually loses its potency.[3]

The decisions that shaped the key elements of the program announced March 14 were taken in light of a full consideration of experience in terms of the scope, cost, and efficacy of previous credit restraint programs. For example, some features of the program were designed to increase its efficacy and prevent its circumvention.

Consumer credit, the sector singled out for special attention, is the one in which the borrowers typically have limited alternative sources of credit. Unlike large corporations, consumers cannot turn to the open market to sell bonds or commercial paper when traditional institutional sources of credit dry up. Within this sector, moreover, the program covered all major sources of credit, not only banks but also finance companies, credit unions, thrift institutions, retail establishments, oil companies, and travel and entertainment card companies.[4]

To get the maximum effect from a limited commitment of resources, the program focused on lenders, who are relatively few in number, instead of borrowers, who number in the millions. It concentrated, then, on the supply of credit rather than the demand for it. Because of the huge administrative problems entailed, few efforts have been made to control the demand for credit. The most prominent example was the Federal Reserve Board's Capital Issues Committee in World War I. The committee screened proposed issues of stocks and bonds over $100,000, approving only the issues conducive to the war effort.

Unlike the credit controls of both World War II and the Korean War, the program did not prescribe specific limits on the nonprice terms of credit transactions, such as minimum downpayments and maximum maturities. The special deposit requirement raised the cost of extending consumer credit. However, the program relied on disclosure and consultation to limit overall extensions of credit. But, aside from an admonition in the Special Credit Restraint Program that "rates should not be calculated in a manner that reflects the cost of relatively small amounts of marginal funds subject to the marginal reserve requirement on managed liabilities," it was left to individual institutions how best to ration credit among particular borrowers.

All these characteristics of the program serve to point up its limited scope and expected short duration. Even more decisive proof of its limited aims is the relatively small commitment of resources and personnel to its implementation.

Fallacies regarding credit control

The temporary nature of the program recognizes fully the demonstrated limitations of credit restraints. However, some proponents of credit controls persist in seeing a

[3]U.S. experience with credit controls beginning in World War I is discussed in Arnold Dill, "Selective Credit Controls: The Experience and Recent Interest," *Monthly Review*, Federal Reserve Bank of Atlanta (May 1971), pp. 78-86.

[4]An unsuccessful Congressional drive for mandatory allocation of bank credit to selective uses was mounted in 1975. A major criticism of these legislative proposals was that nonbank financial institutions were virtually ignored. For a discussion of the 1975 proposals, see Randall C. Merris, "Credit Allocation and Commercial banks," *Business Conditions*, Federal Reserve Bank of Chicago (August 1975), pp. 13-19.

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larger and more enduring role for them.

Recent stabilization policy. Although there is no indication that the cyclical behavior of homebuilding has lowered the industry's long-run growth, it is well established that the extreme swings of homebuilding involve social costs—periodically idle resources and foregone production, bankruptcies of construction companies, excessive startup costs, and inconvenience to the public due to postponement of housing purchases until a later phase of the interest rate cycle. This instability, sometimes diagnosed as the inevitable result of an unregulated economy or of the basic inability of monetary and fiscal policy to moderate the business cycle, has formed the basis for many proposals for imposing permanent credit controls.

This prescription presupposes that the aggregate demand policies followed in recent years have been the best that could be achieved. But for at least two decades, the homebuilding industry has been alternatively the beneficiary and victim of overly expansive and excessively restrictive monetary and fiscal policies.

To take the most recent example, as the economy and the homebuilding industry recovered from the recession of 1974-75, the narrow money supply (M-1) accelerated from an annual growth rate (fourth quarter over fourth quarter) of 4.6 percent in 1975 to 5.8 percent in 1976, 7.9 percent in 1977, and 7.2 percent in 1978, before slowing to 5.5 percent in 1979. That this acceleration was unintended appears clear from repeated statements of Federal Reserve Board Chairmen Burns and Miller that inflation is the nation's most serious economic problem and that a precondition to reducing inflation is a gradual reduction in monetary growth.

Given that the most widely accepted estimate of the lag between changes in the rate of growth of money and the maximal impact on the rate of inflation is two to three years, the strong inflationary pressures seen since late 1979 are not hard to explain. As is generally understood today, the efforts of lenders to protect the purchasing power of their principal cause actual and anticipated rates of inflation to be incorporated in nominal market interest rates. To this preexisting upward pressure on interest rates was added a sharp cutback in the growth of money and credit initiated by the Federal Reserve's more vigorous efforts to achieve its monetary targets and thereby to combat inflation, particularly since adoption of its new reserves targeting procedure on October 6, 1979. It is not surprising that interest rates skyrocketed in the months immediately following the change in operating procedures.

Fiscal policy has not helped much. After being in surplus in 1974, the worst year of the recession, the high employment federal budget went from a deficit of $18.2 billion in 1975 to $18.6 billion in 1977 before declining and turning into a $9.8 billion surplus in 1979. The actual budget has been in deficit consistently in recent years, putting heavy pressure on the credit markets and pushing interest rates even higher than the required degree of monetary restraint would otherwise require.

The overly stimulative fiscal and monetary policies followed during the expansion were shaped, at first, by what was considered the sluggishness of the recovery in 1975 and 1976. They may have continued through 1977 and 1978 because of an exaggerated estimate of the excess capacity in the economy. It has been estimated that economic obsolescence due to the sharp rise in oil prices since 1973 may have reduced the effective capacity of the American economy as much as 5 percent. Failure to give full recognition to this loss may have led policymakers to overestimate the economy's capacity to expand before encountering inflationary pressures.

Policymakers—and many economists, public and private—may have also been deceived by historically high levels of nominal interest rates into believing policy was more restrictive than it turned out to be. Nevertheless, there is little or nothing in the recent expansion to suggest monetary and fiscal policies have lost their potency. What has been demonstrated is that inappropriate policies continued too long can build up a great deal

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of momentum that is not easily reversed. On the positive side, there is reason to believe that avoidance of the same mistakes in the future could prevent much of the enormous volatility in interest rates that has driven homebuilding from a state of frenzy in 1977 and 1978 to a projected depression in 1980, while putting severe financial pressure on farmers, small businesses, and municipal governments.

Availability versus interest rates. The discredited, long dormant, but never dead assertion that high interest rates cannot slow credit expansion has been heard more and more frequently in recent years. Interest rates have risen continuously, but credit has continued to grow. The lesson—as often observed by Governor Wallich—is that a 17 percent prime rate, though historically high, is not restrictive when the annual inflation rate (as measured by the Consumer Price Index) is also around 17 percent.[5] It should be recalled, moreover, that as late as early September 1979, the prime rate stood at only 12¼ percent. Depending on how price expectations are measured, the real (inflation adjusted) burden of borrowing at the prime rate may have been no higher than 2 or 3 percent, and conceivably negative, through last September.

The evidence is clear, however, in the form of falling prices of sensitive commodities, slowing retail sales, and other signs of declining economic activity, that the subsequent rise in interest rates to 20 percent was adequate to the task. As tight credit continues to do its job, perhaps to excess, the recurring doctrine of its impotence should at last be put to rest. The timing of the introduction of the credit restraint program may result in its receiving the credit (or blame) for what were actually the results of high interest rates. Its primary effect was to cushion the harsh impacts of those high rates on particular sectors.

Interest rates and inflation. Another particularly durable fallacy with widespread support today is the notion that high interest rates are not only ineffectual in combating inflation but perverse. The argument is that interest represents a major cost to business and increases in interest costs are passed along in the prices of products. It is hard to trace the origins of this doctrine, but it was conclusively discredited by the prominent Swedish economist, Knut Wicksell, around the turn of the century. Maybe because of its common sense appeal, it remains a staple among many bankers and businessmen today.[6]

The essential error of the doctrine is that it combines a partial equilibrium analysis of the effects of high interest rates (an analysis limited to the adjustment of a single firm, taking other factors as given) with a naive cost-plus theory of product pricing, ignoring demand. Although the immediate effect of rising interest rates may be to raise business costs and induce price increases, the dampening effect of higher rates on spending will eventually reduce demand, idle productive resources, and put downward pressure on all prices.

Much of the support for the doctrine comes from the evident empirical association of high interest rates with high rates of inflation. However, as indicated above, this association largely reflects the incorporation of inflationary expectations into nominal interest rates. That both high interest rates and persistent inflation are generally associated with sustained high rates of monetary growth buttresses this conclusion.

This particular fallacy might seem to have crept into the credit restraint program in the form of its imposition of a surcharge only on persistent borrowing at the discount window by large banks and the admonition to lenders in the Special Credit Restraint Program not to base lending charges on the high cost of marginal funds. A close reading of the program's provisions, however, reveals that the Federal

[5]A recent statement to this effect is in Henry B. Wallich (remarks to the Swiss-American Society Basel, Basel, Switzerland, June 10, 1980; processed).

[6]For a thorough analysis of the doctrine, see Thomas M. Humphrey, "The Interest Cost-Push Controversy," *Economic Review*, Federal Reserve Bank of Richmond (January/February 1979), pp. 3-10.

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Reserve's effort to moderate increases in rates was based not on the mistaken notion that high interest rates are inflationary, but on its concern over the sectoral incidence and distributional effects of high rates.

Inflation and the uses of credit. Like its predecessors, the credit restraint program distinguishes between productive and nonproductive activities. Banks were urged "to avoid financing for purely speculative holdings of commodities or precious metals or extraordinary inventory accumulation" and "to discourage financing of corporate takeovers or mergers and the retirement of corporate stock." The primary reason for avoiding such speculative lending is to help maintain the flow of credit to, and moderate dislocations in, the interest-sensitive sectors of the economy.

But it is also occasionally argued that lending for nonproductive activities is inflationary. This is an extraneous argument that appears to involve the fallacy of generalization about wholes based on analysis of parts. Credit used to finance speculation in commodities and inventories will certainly help drive up prices of the affected goods in the short run. But it will prove profitable in the long run only if speculators have correctly anticipated future demand. To the extent that they guess right, the net effect is that prices rise sooner than they would otherwise and there is a socially beneficial reallocation from present to future consumption. If they guess wrong, prices will fall as speculative positions are liquidated.

More critically, credit used to speculate in one commodity is not available for bidding up (or maintaining) the prices of other commodities. Hence, any undue upward pressure on some prices due to speculation on credit will be offset by downward pressures on other prices. The net effect on the price level overall should be limited to increases that can be attributed to increases in total credit.

In the case of credit used to finance mergers and takeovers and other purely financial transactions, the concern seems to be that these represent a withdrawal of credit from more productive uses, such as net investment in plant and equipment. But here a distinction has to be drawn between credit as seen by individual enterprises and credit in the context of the economy. To a firm, having credit available is tantamount to having a desired new piece of equipment. One is exchangeable for the other in the marketplace. But for the economy as a whole, credit, like money, is simply a claim on real resources. Multiplying the claims does not multiply the resources. It simply bids up their prices.

A withdrawal of some part of the available supply of credit from financing real investment and consumption to financing transfers of ownership or purchases of common stock should actually reduce the demand for real goods and tend to lower their prices. In no sense can this be called inflationary.[7]

A striking illustration of this point was the credit-fueled boom in the stock market in the late 1920s. Although banks withdrew credit from industrial purposes to lend to speculators that, in turn, bid stock prices up to unprecedented—and as is now clear, unsustainable—levels, there was no similar evidence of overheating in the real sector of the economy. Consumer prices actually fell throughout the second half of the 1920s.[8]

Investment and inflation. The only distinction between uses of credit that has any major significance for inflation—and one also stressed in the credit restraint program—is that between consumption and investment. As often observed, the use of credit to increase productive capacity can increase the supply of goods in the future relative to any given level of demand, reducing future inflation.

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[7]This point was made recently in Paul M. Horvitz, "In Defense of Nonproductive Loans," *American Banker*, November 5, 1979.

[8]The divergent behavior of commodity and security prices during the late 1920s is discussed at some length in Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton University Press, 1963), pp. 251-66, 289-92, and 699. The same point was made earlier in Clark Warburton, "Monetary Difficulties and the Structure of the Monetary System," *Journal of Finance*, vol. 7 (December 1952), pp. 523-45.

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Though true, this argument needs to be qualified. First, the division of current output between consumption and investment reflects the preference of people for current consumption over future consumption. It is not clear that any compelling social reason can be adduced to override those preferences.

Second, redistributing demand from consumption to investment cannot be expected to have any effect on current inflation. The increases in the supplies of goods it promises lie in the future. Most important, even a doubling of the increase in productivity from its historical rate of 2.5 percent a year—a wholly unrealistic goal—would make only a minor contribution toward curing an inflation rate of more than 10 percent.[9]

[9]The limited role of investment in combating inflation is described in Martin Feldstein, "Inflation and Supply Side Economics," *The Wall Street Journal*, May 20, 1980.

Conclusions

The emphasis in the credit restraint program on curbing the growth of total credit had an important but distinctly limited contribution to make in controlling inflation. The program may, however, have made the application of tight monetary policies more politically palatable by mitigating the harsh sectoral impacts of high interest rates.

The role of credit in the inflationary process is still a matter of debate. Some would argue that the crucial element in controlling aggregate demand and, therefore, inflation is not total credit, but money. Nevertheless, given the close secular relationship between the growth of money and the growth of credit, the implications for monetary and fiscal policy are similar in either case. Without long continued restraint in both the expansion of bank reserves and government spending, no anti-inflation policy can be effective.

Phase-out of the Selective Credit Restrictions

The Board on July 3 released a schedule for the complete phase-out of its program of selective credit restrictions. Stating that the program was no longer necessary, the Board cited the moderate credit growth, particularly at banks, for the first six months of 1980 and the slowing of demands for consumer credit and credits of an anticipatory or speculative nature.

Effective with the reserve computation week beginning July 10, the 5 percent marginal reserve requirement on managed liabilities of large member banks, and similar special deposit requirement on large nonmembers, were eliminated. (A 2 percent supplementary reserve requirement on large time deposits of member banks, introduced in November 1978, also was eliminated.) The Board abolished the 7½ percent special deposit requirements on increases in consumer credit and assets of money market funds—effective for consumer credit extended in June and for previously covered assets of money market funds after July 20.

The Board on July 3 also announced its intention to phase out the Special Credit Restraint Program limiting domestic loan growth at banking institutions and finance companies to a 6 to 9 percent range. The Board's decision to dismantle the program was conditioned on the slower expansion of bank loans to domestic borrowers, which grew at an annual rate of only 3 percent during the first five months of the year. Experience with the program was to be discussed with individual banks following receipt of final reports due July 10. Although the Board indicated that the Special Credit Restraint Program had served its purpose, it remained concerned over the volume of credit extended for speculative purposes in the past and was considering ways to monitor such developments in the future.

In announcing these measures, the Board emphasized the temporary nature of the credit restraint program and the fact that it had been designed to supplement more general measures of monetary restraint. The Board reaffirmed its goal of restraining the growth of money and credit in order to achieve a further reduction of inflationary pressures in the economy.

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The history of potential competition in bank mergers and acquisitions

W. Stephen Smith

The theory of potential competition and its application to the banking industry has been a subject of continuing controversy since the 1960s, when banks and bank holding companies (BHCs) began to expand the geographic scope of their activities through mergers and acquisitions. During the past decade the policy of the Board of Governors of the Federal Reserve System toward acquisitions involving potential competition has come full circle. Prior to 1975 potential competition was accorded an important role in Board denials. Then, between May 1975 and November 1979, with one limited exception,[1] the Board did not deny an application solely on the basis of potential competition. Since then, however, potential competition has again been emphasized in the Board's analysis of the competitive effects of bank mergers and acquisitions. The past, present, and future roles of potential competition in the regulation of banks and bank holding companies are discussed in this article.

The origin of the potential competition theory

In the years following World War II, corporate mergers occurred primarily between

The economics of potential competition

Traditional microeconomic theory argued that, in the absence of government interference, firms in markets in which sellers were few would recognize their economic interdependence and collusively determine market price and output in order to earn higher-than-competitive rates of return. With complete freedom of entry, however, such cooperation would yield only short-term economic gains. Excessive profitability in a market would attract additional competitors, each of which would cause a rise in market output and a corresponding drop in market price until, eventually, all firms would be earning a normal rate of return. In the presence of significant barriers to entry, however, firms in a market would continue to earn above normal rates of return without inducing additional entry.

While the theory of potential competition dates to the turn of the century, it was not formalized until the 1950s and 1960s, when Joe Bain and Sylos-Labini developed "limit pricing" models to approximate firm pricing decisions when various levels of entry barriers are present.[2] These models suggest that an optimal corporate policy may involve setting prices which do not maximize short-run profits in order to deter entry by new competitors. The modern theory of potential competition thus evolved from the theory of limit pricing. Basically, it states that a firm (the potential competitor), even though it has not entered a given market, may influence the price-output decisions of the firms in that market.

[1]The Board of Governors' denial of Northwest Bancorporation's application to acquire First National Bank, Fort Dodge (63 Federal Reserve Bulletin [FRB] 585 (1977)) was overturned upon reconsideration (63 FRB 1096 (1977)).

[2]Joe S. Bain, "A Note on Pricing in Monopoly and Oligopoly," *The American Economic Review*, vol. 39 (March 1949), p. 448. Paolo Sylos-Labini, *Oligopoly and Technical Progress* (Cambridge, Massachusetts: Harvard University Press, 1962).

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directly competing firms. By the early 1960s, however, this trend tapered as the Justice Department won several significant suits blocking such horizontal merger activity. Businesses responded logically to this new regulatory and legal environment by acquiring firms outside their traditional product and/or geographic markets. As these product and market extension mergers became more commonplace, the Justice Department and various regulatory agencies looked for a method to analyze the competitive impact of these actions. Their answer, in large part, was the theory of potential competition.

As the potential competition theory came into use in judicial and regulatory circles, three types of potential competitors were distinguished:[3]

- The **dominant entrant** is a firm which has such enormous resources that it can wield monopoly power upon entering a market.
- The **potential entrant** is a firm which, by virtue of its perceived ability and intent to enter a given market, causes the firms in that market to behave more competitively.
- The **probable future entrant** is a firm which, though it seeks to enter a given market through acquisition, may not have altered the competitive behavior of the market's participants. Permitting this firm to enter precludes the possibility that it could have eventually deconcentrated the market through a de novo or foothold acquisition.

Potential competition and the Supreme Court

Beginning in the late 1950s, the Antitrust Division of the Department of Justice sought to bring merger cases involving potential competition under the purview of Section 7 of the Clayton Act.[4] Having accomplished this task in a series of industrial cases, it then attempted to extend the potential competition doctrine to the banking industry. The Justice Department's early experience in this area was singularly unsuccessful. Beginning with the *Crocker-Anglo* decision in 1967,[5] Justice lost four consecutive potential competition cases involving the banking industry before deciding to appeal to the Supreme Court the attempt by Colorado's First National Bancorporation to acquire the First National Bank of Greeley.

The Greeley decision

First National Bancorporation (FNB) owned the controlling interest in Denver's First National Bank, the largest bank in both Denver and the state of Colorado. At the time, Colorado's banking structure was shifting from being primarily composed of independent unit banks to being dominated by multibank holding companies (MBHCs). As a result, the major BHCs were looking for acquisition candidates throughout the state.

At the time FNB applied to acquire First National, the second largest bank in the Greeley market, it also applied to acquire the largest bank in Pueblo and the second largest banks in Boulder and Colorado Springs. The Board of Governors denied the Pueblo acquisition on potential competition grounds, approved the Boulder acquisition because the bank to be acquired was in financial trouble, and narrowly approved the Colorado Springs

[3]Stephen A. Rhoades, "A Clarification of the Potential Competition Doctrine in Bank Merger Analysis," *Journal of Bank Research*, vol. 6 (Spring 1975), p. 35. *U.S. v. Falstaff Brewing Corp.*, 410 U.S. 526 (1973).

[4]Clayton Act Section 7, as amended in 1950, reads in part:

> That no corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital . . . or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or tend to create a monopoly.

[5]*U.S. v. Crocker-Anglo National Bank*, 277 F. Supp. 133 (N.D. Calif. 1967).

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and Greeley acquisitions. The Justice Department filed suit in the latter two cases, alleging violations of Section 7 of the Clayton Act, and FNB subsequently dropped its plans to acquire the bank in Colorado Springs.

First National Bank of Greeley was the largest independent bank in its market with total deposits of $39.2 million, about 34 percent of the market. The Justice Department argued that the elimination of FNB as a potential competitor in the Greeley market constituted a violation of the Clayton Act. The District Court disagreed with this contention for four reasons: FNB officials had testified that they had no intention of entering the Greeley market except by acquiring a leading bank; de novo entry was unlikely because the market was adequately banked and experiencing only moderate growth; regulatory officials testified that approval of future de novo applications was unlikely; and foothold entry was not "a likely possibility" because the only available small unaffiliated bank was not then for sale.

The District Court's ruling against the government was upheld in a 4-4 decision by the Supreme Court.[6] Thus, not only did the Court fail to express an opinion on the application of the potential competition doctrine to banking, but no one could even be sure which justice voted which way.

It is interesting to note the events that transpired in the year and a half following the District Court's Greeley decision. First, FNB, which had argued that it would only enter Colorado Springs by acquiring a leading bank, acquired a local bank with less than 20 percent of the deposits of the bank it initially sought to acquire. Second, after being denied acquisition of the largest bank in the Pueblo market, FNB acquired a bank less than one-third as large. Third, the foothold bank in Greeley, which the District Judge ruled was not likely to be sold, was in fact sold to another Colorado BHC. Fourth, after the District Court had accepted the testimony of regulators that de novo applications would not be approved, the state banking commission granted another BHC approval to establish a new bank in the Greeley market. Finally, the banks which FNB sought to acquire in Pueblo and Colorado Springs formed their own MBHC and subsequently entered the Denver market, competing directly with FNB's lead bank.[7]

The Falstaff decision

The same day the Supreme Court handed down the "Greeley" decision, it also clarified some potential competition issues in its opinion in *U.S. v. Falstaff Brewing Corp.*[8] Falstaff, the fourth largest beer producer in the country at the time, sought to enter the New England market by acquiring the market's largest brewer. The District Court held that, in its judgment, Falstaff would never enter the New England market on a de novo or foothold basis, and therefore could not be considered a potential entrant.

The Supreme Court overturned the District Court, ruling that potential entrants are within the scope of the potential competition doctrine. The Court left unresolved, however, whether probable future entrants are also within the scope of the doctrine.

The Marine decision

The Supreme Court issued its first opinion applying the potential competition doctrine to banking in its June 1974 decision, *U.S. v. Marine Bancorporation*.[9] In *Marine*, the Court approved the merger of Washington Trust Bank (WTB) of Spokane, the third largest bank in the Spokane market, and Seattle's National Bank of Commerce (NBC), the second largest bank holding company in the state of Washington.

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[6] *U.S. v. First National Bancorporation*, 410 U.S. 577 (1973).

[7] Donald Baker, "Potential Competition in Banking: After Greeley, What?" *Banking Law Journal, vol. 90 (May 1973), p. 362.*

[8] *U.S. v. Falstaff Brewing Corp.*, 410 U.S. 526 (1973).

[9] *U.S. v. Marine Bancorporation,* 418 U.S. 602 (1973).

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The Court agreed with the Justice Department's arguments that the potential competition doctrine was applicable to commercial banking, and that the Spokane market was sufficiently concentrated for the doctrine to be a relevant consideration in the case. It noted, however, that determining the extent of the loss of potential competition in banking markets depends largely on a state's branching laws, which can limit the effective alternatives for entry.

The Court, therefore, held that NBC was not a potential entrant. Banks in the Spokane market, the court majority reasoned, must have recognized that the state's branching restrictions made NBC's entry into the Spokane market infeasible, except by merger with WTB.

The Supreme Court did not rule on whether elimination of probable future competition constitutes a violation of the Clayton Act. In the Court's opinion, the Justice Department failed to establish that feasible means of entry existed and that there was a reasonable prospect of long-term structural improvement or benefits in the target market.

Foothold entry, the Court reasoned, would not be a feasible alternative because the only bank available in the downtown area could not be purchased for four years. Even then, state law would preclude NBC from branching from this location, thus limiting the procompetitive impact of such an acquisition. The Court deemed NBC's other entry alternative, sponsoring a bank and acquiring it later, to be feasible at some indefinite future date, but felt that it was not likely to produce greater competition since NBC could not legally branch from the sponsored bank.

Therefore, the Justice Department did not establish, prima facie, that NBC was a probable future competitor. As a result, the Court did not address the issue of the legality of bank mergers which, while not reducing the present level of competition, might preclude future market deconcentration through de novo or foothold entry.

The Board of Governors and potential competition

Beginning in the early 1960s, it was not uncommon for the Board of Governors to deny a proposed merger on the basis of an adverse impact on potential competition. These denials invariably involved acquisition of one of the leading banks in a market by one of the state's largest bank holding companies. Beginning in 1975, however, the Board grew increasingly reluctant to deny applications on potential competition grounds alone. In fact, it was not until November 1979 that potential competition became a viable issue once again. The Board of Governors' attitude toward potential competition in banking can best be illustrated by analyzing specific issues in some key Board decisions.

The Tyler Doctrine

The first major potential competition denial in the mid-1970s involved an attempt by First International Bancshares of Dallas, the largest BHC in Texas, to acquire Citizens First National Bank of Tyler, the largest bank in the Tyler market.[10] The reasoning behind the January 1974 denial, which became known as the "Tyler doctrine," consisted of two elements:

First, observing that the share of total state deposits held by the five largest BHCs in Texas had increased from 22 percent in 1970 to 31 percent in 1973, and that the same five companies held two-thirds of the deposits of all 24 BHCs, the Board wanted to prevent any worsening in the concentration of state deposits.[11]

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[10] 60 FRB 43 (1974).

[11] Denial orders based on potential competition frequently discuss the adverse impact on statewide concentration because, as a rule, the cases involve an acquisition by one of the state's largest BHCs. Theoretically, however, the two issues are distinct: if there is an adverse competitive impact, the change in statewide concentration should be irrelevant. However, a case might arise in which the adverse competitive effects are not significant enough to warrant denial unless combined with the impact on statewide concentration.

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Second, because Tyler was the leading bank (30 percent of market deposits) in a highly concentrated market, and because the Tyler market was attractive for de novo entry, the Board argued that the acquisition would harm competition within the Tyler market. De novo or foothold entry, it concluded, represented the only means of providing more competition.

Austin: Before the pendulum swings

An equally important decision was the Board's February 1975 order denying the application by Texas Commerce Bancshares (TCB) of Houston, the third largest BHC in Texas, to acquire Austin National bank (ANB), the largest bank in the Austin market.[12] There was no existing competition between the two organizations.

The Board emphasized that it was "primarily concerned with the significantly adverse effects . . . on the concentration of banking resources *within* the Austin banking market" (emphasis added). It denied the application and stated that the acquisition would have an adverse impact on potential competition in that it would:

- appreciably reduce the likelihood that the market would become less concentrated and more competitive in the future through continued potential competition from TCB;
- eliminate ANB as a lead bank for a BHC that would continue to compete in Austin as well as possibly expand into a regional holding company; and
- eliminate TCB as a "new and aggressive competitor" via de novo entry.

The Texas turnaround

The ANB decision and the Board's position on potential competiton were, in essence, overturned in May 1977 when the Board approved TCB's application to acquire Capital National Bank (CNB) in Austin.[13] CNB was the second largest bank in the Austin market with 21.4 percent of total deposits, slightly less than the 23 percent share of ANB. As with ANB, no existing competition issues were involved.

The Board, however, reversed two of its three conclusions regarding the impact of such an acquisition on potential competition in the Austin banking market. First, acknowledging that "the level of concentration of banking resources in the Austin market has not changed appreciably "since the previous denial, the Board concluded that it

> does not *now* view Applicant's acquisition of Bank as significantly reducing the likelihood that the market would become less concentrated in the future (emphasis added).

The stated reason for this reversal was that, given the attractiveness of the Austin market for de novo entry,

> approval of this application would not foreclose the possibility of such other competitors entering the market de novo or through acquisition of one of the many independent banks.

Of course, the Board had found the Austin market attractive to de novo entry in the ANB case as well. Since neither the ANB nor the CNB acquisition would have foreclosed de novo or foothold entry by these other competitors, the change in attitude apparently reflected the change in the Board's composition.[14]

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[12]61 FRB 109 (1975).

[13]63 FRB 500 (1977).

[14]Of the six Governors who voted to deny the ANB acquisition, only one, Governor Wallich, voted to deny the CNB acquisition. Voting to approve the CNB acquisition were the four Governors who were not members of the Board at the time of the ANB application and Governor Burns and Coldwell, who had previously voted to deny the ANB application.

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Second, the Board had contended that potential competition would be reduced since ANB could serve as the lead bank for another BHC. CNB, a bank the same size as ANB, could also have become the lead bank for a regional BHC while remaining an active competitor in the Austin market. In the CNB order, however, the Board does not discuss this issue.

Finally, the Board had stated in the ANB order that approval of the acquisition would have an adverse effect on competition by *eliminating* TCB as "a new and aggressive competitor" through de novo entry. In CNB, however, the Board reversed its opinion, stating that "approval of this application may have a positive effect on competition in the market by *introducing* a new and aggressive competitor" (emphasis added). Comparison of the arguments used to justify these contradictory conclusions seems to favor the logic of the ANB case. Though TCB became a new competitor in Austin upon consummation of the CNB acquisition, CNB was eliminated as a competitor; thus, one competitor was merely substituted for another. In the ANB case, on the other hand, had TCB entered the market de novo, the two organizations would have competed head on.

Recent revisions: First City and Old Kent

After the approval of TCB's acquisition of CNB, the Board did not deny an application solely on the basis of potential competition until its November 1979 decision on Old Kent Financial Corporation's application to acquire Peoples Banking Corporation of Bay City, Michigan.[15]

The Board's new attitude first emerged in its September 1979 four-to-three approval of First City Bancorporation's [FCB] acquisition of First Security National Corporation [FSN] of Beaumont, Texas.[16] The order stated:

> . . . it is not the Board's intention to suggest by this Order that it will generally approve the acquisition of leading local market competitors by major statewide organizations. To the contrary, this case approaches the limits in terms of the size of the banking organization being acquired and the effects on competition and concentration of what the Board will regard as approvable in light of present structural and legal considerations.

FCB was the second largest banking organization in Texas with 8.2 percent of total state deposits, while FSN was the 17th largest with 0.6 percent of deposits statewide. The Board expressed particular concern about the effects on potential competition in the Beaumont market, in which FSN was the leading organization, controlling 24.1 percent of market deposits.

The "limits" referred to in First City were apparently exceeded by Old Kent in its attempted acquisition of Peoples. Old Kent was the sixth largest banking organization in Michigan with 3.5 percent of total state deposits, while Peoples was the 12th largest with 1.6 percent of deposits statewide. The Board argued that the proposed acquisition would have eliminated potential competition. Although there were no banking markets in which subsidiaries of both Old Kent and Peoples operated, each holding company was among the dominant organizations in the majority of markets it served. Since Old Kent several proposed acquisitions have been denied on largely the same grounds.[17] The Board majority in these cases used essentially the same arguments that had been made in the previously cited denials of the mid-1970s and the dissents of the late 1970s.[18] Thus, present Board policy maintains that, in general, the largest BHCs in a state will not be permitted to acquire the leading banks in a

[15]65 FRB 1010 (1979). See note 1.

[16]65 FRB 862 (1979).

[17]DETROITBANK Corporation (Second National Corporation), 66 FRB 242 (1980); The Marine Corporation (First National Bank and Trust Co., Racine), March 26, 1980; Mercantile Texas Corporation (Pan National Group), April 16, 1980.

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concentrated market when foothold or de novo entry is a feasible alternative.

Empirical evidence

A major factor contributing to the Board's changing policy with respect to the potential competition doctrine has undoubtedly been the lack of any empirical verification of the doctrine and its major assumptions. As postulated, the doctrine makes three implicit assumptions:

- that higher levels of market concentration are associated with above-normal rates of return;
- that de novo or foothold entry will produce market deconcentration and improve performance; and
- that the Board or the courts can accurately predict future entry.

Economic studies to date have generally supported the first assumption. A 1977 paper by Rhoades summarizes the results of 39 studies of the structure/performance relationship in banking undertaken since 1959.[19] Thirty of these studies found a statistically significant relationship. Rhoades concludes that while "market structure clearly affects price and profit performance in commercial banking, . . . the effect is quantitatively small." However, Rhoades notes that more conclusive findings would result from employing improved methodology in future empirical work.

Much less empirical work has been done on the second assumption. The impact of foothold entry on market structure was the subject of a 1978 study by Rhoades and Schweitzer.[20] They employed multivariate regression techniques to analyze the changes in market structure in 70 markets during the period 1966 to 1976 and found no statistically significant relationship between foothold entry and changes in concentration. The authors observed, however, that their conclusions, if accurate, did not necessarily imply that performance in these markets was not improved by foothold entry; additional competition might have been induced by the new entrant, even though market shares had remained constant. No study has provided strong evidence of the impact of de novo entry on market structure.

While the impact of foothold entry on market performance has not been tested empirically, McCall and Peterson have analyzed the impact of de novo entry on market performance.[21] Their results indicate that de novo entry has a positive effect on performance (decreasing prices without reducing profits to threatening levels) in states with restrictive branching laws, while in the other states de novo entry has a negligible impact.[22] McCall and Peterson conclude that this difference may well be due to the fact that the less restrictive branching laws have promoted greater competition.

There is also limited empirical evidence regarding the third assumption. Rhoades examined 50 cases of merger denials from

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[18]Texas Commerce Bancshares, Inc. (Bancapital Financial Corporation), 63 FRB 500 (1977); First City Bancorporation of Texas (City National Bank of Austin), 63 FRB 674 (1977); DETROITBANK Corporation (Lake Shore Financial Corporation), 63 FRB 926 (1977); Northwest Bancorporation, 63 FRB 1096 (1977); First City Bancorporation of Texas, Inc. (Lufkin National Bank), 64 FRB 969 (1978); First City Bancorporation of Texas, Inc. (First Security National Corporation), 65 FRB 862 (1979); National Detroit Corporation (Farmers and Merchants National Bank), 65 FRB 928 (1979).

[19]Stephen A. Rhoades, *Structure Performance Studies in Banking: A Summary and Evaluation*, Staff Economic Studies 92 (Board of Governors of the Federal Reserve System, 1977).

[20]Stephen A. Rhoades and Paul Schweitzer, *Foothold Acquisitions and Bank Market Structure*, Staff Economic Studies 98 (Board of Governors of the Federal Reserve System, 1978).

[21]A. S. McCall and M.O. Peterson, "Impact of De Novo Commercial Bank Entry," *Journal of Finance*, vol. 32 (December 1977), p. 1587.

[22]This finding is interesting in light of the Supreme Court's conclusion in *Marine Bancorporation* that de novo entry is a less viable alternative in states with restrictive branching laws.

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1960 to 1975 in which subsequent entry was predicted. He found that 68 percent of the 1960-69 predictions were realized by mid-1975, and that 36 percent of the 1970-75 predictions were realized by August 1977.[23] The study thus gives a good preliminary indication that the Board has been fairly accurate in predicting subsequent entry in the cases it has denied. There is, of course, no way of measuring the number of approvals which, had they been denied, would have resulted in subsequent entry. Without that information, it is difficult to assess the overall accuracy of the Board in forecasting de novo or foothold entry.

The potential competition doctrine: How far have we come . . .

The Board of Governors has led the Supreme Court in the development and application of the potential competition doctrine, particularly with respect to the banking industry. The Court has held that elimination of potential competition can constitute a violation of the Clayton Act. It has also held that this doctrine applies to the banking industry. However, the Court has never found a banking organization to be guilty of a Clayton Act violation on the basis of potential competition. More importantly, the Court has yet to rule, in either a banking or industrial context, on whether the elimination of probable future competition constitutes a violation of the Clayton Act.

While the Board has denied acquisitions which would eliminate potential or probable future competition, it has not done so consistently. This vacillation is probably attributable to the lack of empirical evidence to support the theory of potential competition. The Board has had a longstanding policy of denying acquisitions within the same market, but, as noted above, there is a large body of theoretical and empirical evidence demonstrating the anticompetitive consequences of these horizontal acquisitions. Since neither the Board nor the courts have had the benefit of a theoretical and empirical consensus regarding potential competition, it is not surprising that the Board's use of the doctrine has varied with the Board's composition, and that the courts have been reluctant to address the issue at all.

. . . and where do we go from here?

There is obviously an urgent need to assess empirically the theory of potential competition. If the resulting evidence provides a clear picture of the competitive impact of leading bank acquisitions by large BHCs, it will undoubtedly help formulate a long-term consensus at the Board regarding the potential competition doctrine. However, until such evidence emerges, if it ever does, the question remains: what costs are associated with different potential competition policies?

In order to answer this question, two scenarios are analyzed. First, what would be the costs of pursuing a strong potential competition policy if, in reality, there are few harms associated with the elimination of potential competition? The most significant costs would be incurred by the shareholders of the banking organizations involved in the acquisition.[24] When the Board denies an application, it may be forcing a banking organization to forego some short-run return on its capital.[25] Absent any socially beneficial increase in competition, this cost to shareholders represents a net loss to society.

Second, what would be the major costs of pursuing a weak potential competition policy if, in reality, there are significant harms

[23]Stephen A. Rhoades, "Probable Future Competition and Predicting Future Entry in Bank Merger Cases," *Antitrust Bulletin*, forthcoming.

[24]Most studies show little advantage to consumers from BHC affiliation. See Dwane B. Graddy, *The Bank Holding Company Performance Controversy* (Washington, D.C.: University Press of America, Inc., 1979) and, most recently, Stephen A. Rhoades and Roger D. Rutz, *Impact of Bank Holding Companies on Competition and Performance in Banking Markets*, Staff Economic Studies 107 (Board of Governors of the Federal Reserve System, 1979).

[25]Assuming the banking organization has alternative investment opportunities, the cost in terms of foregone return on capital is represented by the rate of return on the bank acquisition minus the rate of return on the most profitable investment alternative.

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associated with the elimination of potential competition? The cost to the consumer from decreased competition is higher prices, fewer, and/or lower quality services. These costs are usually analyzed in two parts: deadweight loss and transfer loss. Deadweight loss is a net cost to society that results from the fact that some people will stop using banking services when the price of these services rises. Transfer loss is the income that is transferred from consumers to the banks when price increases force consumers to pay more for the same quality services.

Moreover, the Board's history of pursuing different policies not only incurs the costs described above, but each policy shift imposes an additional cost upon the shareholders of banking organizations that were planning acquisitions on the basis of the Board's policy before the shift took place.

Quantifying and comparing these costs is a difficult empirical task, given the uncertain and subjective nature of the issues involved. Consequently, there is no potential competition policy that is clearly optimal in an uncertain environment. However, two additional considerations lend weight toward favoring a strong potential competition policy.

First, the costs associated with a weak policy affect a larger number of people in a more basic way. Consumers of banking services outnumber the shareholders of banking organizations. Moreover, the loss to any single shareholder is likely to be small, and the shareholder has the option of reorganizing his investment portfolio. The consumer, on the other hand, has no practical alternative to banking in his local market.

Second, the costs associated with a weak policy are permanent. Acquisitions approved by the Board are, for the most part, irreversible. If it turns out that a strong policy is preferable, the resulting higher prices and fewer services are likely to continue indefinitely. In contrast, under a strong policy, denied acquisitions can be approved at a later date, with the cost to the shareholders being incurred only in the interim period.

Summary

The potential competition doctrine was initially developed and applied in an industrial context. While the Supreme Court has found the concept applicable to the banking industry, it has yet to review a banking case in which the elimination of potential competition constituted a violation of Section 7 of the Clayton Act. Moreover, the Court has never considered a case involving probable future competition, and, as a result, has never ruled on whether the elimination of such competition violates the Clayton Act.

The Board of Governors has led the Supreme Court in applying all three forms of the potential competition doctrine to mergers and acquisitions in the banking industry. Its application of these concepts, however, has shifted with the composition of the Board. This inconsistency is probably due, in large part, to the lack of empirical studies testing the assumptions underlying the potential competition doctrine.

Until such empirical evidence emerges, if it ever does, the Board faces the problem of formulating policy in an uncertain environment. While the major costs and benefits of pursuing alternative policies can be identified, quantifying the absolute and relative magnitudes of these costs and benefits is a difficult empirical task.

The Board of Governors is presently pursuing a relatively strong potential competition policy. While there are costs associated with any of the Board's available alternatives, the potential costs associated with a strong policy appear to be significantly lower than those associated with a weak policy. Moreover, the available empirical evidence, limited as it may be, tends to support the assumptions underlying the potential competition doctrine. Thus, until the uncertainties regarding the doctrine can be resolved, the Board can best serve the public interest by making a firm commitment to pursue the strong potential competition policy established in recent months.

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