concentration-profitability relationship existed only in a period when geographic and product market barriers to competition were relatively high.

The mean return on assets for Pennsylvania alone are markedly different from those of Ohio, and generally not in line with those expected if the traditional structuralist theory is presumed to be valid. In particular, mean returns for the two market types with relatively large numbers of competitors (seven or more rural markets and SMSA's) are greater than those in the two more concentrated classes in two of the three time periods. Virtually none of the differences in mean returns are statistically significant. Only two significant differences are evident and only in the 1982-1985 period. However, the tests indicated that mean returns in the two least-concentrated market categories are significantly greater than those for banks in the 4.6 bank markets. This is the opposite of what a structuralist would expect (the t-stats are 2.60 and 2.76, respectively).

Analysis of the data for the combined sample yields results similar to that of Ohio alone. However, as in Ohio, the profitability of banks in the most-concentrated market class is significantly greater than those in each of the other less-concentrated classes only in the earliest period (the t-stats are 2.40, 1.65 and 2.66, respectively). In addition, the mean returns of banks in the "seven or more bank" class are significantly above those of SMSA banks over the same time span. No other significant differences are evident.

Summary and Conclusions
The traditional view that high concentration typically results in undesirable conduct and performance (monopolistic behavior) has come under attack in recent years. In essence, opponents cite the constraining influence of potential competitors on the actions of incumbent firms. The view that market structure is a relatively unimportant determinant of firm behavior presupposes that barriers to entry into any market are minimal.

Some observers allege that the regulatory and technological changes that have taken place in the financial services industry in recent years have significantly eroded barriers to competition between bank and nonbank financial institutions, making local banking markets contestable. The implication is that high concentration in such markets is unlikely to result in anticompetitive conduct, and so is not a cause for concern. Others maintain that meaningful barriers to competition continue to exist and that substantial increases in concentration should be prevented.

The evidence reviewed here is consistent with what one would expect to find if banking markets were, in fact, contestable. A significant relationship between market concentration and bank profitability was detected for the sample banks over the 1976-1978 interval, but in no other more recent time period. The disappearance of the relationship coincided with the liberalization of branch banking laws in Ohio and Pennsylvania and the expansion of S&L powers authorized by Congress in 1980 and 1982.

The findings imply that merger-related increases in concentration in states with minimal barriers to geographical expansion by banks are unlikely to result in monopoly profits for institutions in local markets affected.

If such mergers are in fact motivated by a desire to gain efficiencies, preventing them because of their impact on concentration would appear to be costly to society. Mergers that increase concentration might be opposed for a variety of non-economic reasons. However, actual social benefits from preventing these mergers should be balanced against the potential economic efficiency gains that are lost.

9. Note that there are only a few Pennsylvania banks in the two most-concentrated markets.

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ECONOMIC COMMENTARY

Economic and Bank Profitability: Recent Evidence
by Gary Whalen

The nature of the relationship between the empirical finding that mergers and acquisitions that boost concentration to some relatively high level should not be permitted. In essence, this has been the position of the Justice Department and bank regulators.

However, some economists have argued that the Chicago School of economic thinking is not the best approach to the problem of market concentration. They maintain that monopoly power can only exist and persist if barriers prevent new firms from entering the market. In response, other economists have argued that entry barriers are not the only factor that determines market structure and performance. They suggest that other factors, such as economies of scale and the desire to control the market, may also be important.

Chicago School economists cite the government's role in the decision-making process as a reason for its reluctance to permit mergers. They argue that the government should not be allowed to interfere with the market's natural tendency to balance concentration and competition. However, others maintain that the government has a responsibility to protect the public interest by ensuring that competition is not impaired.

In conclusion, the debate over market concentration and competition is likely to continue for some time. As new evidence emerges, it will be important to evaluate the relative merits of the various perspectives and to determine the most effective way to manage the trade-offs between concentration and competition.

Gary Whalen is an economist at the Federal Reserve Bank of Cleveland. The views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.


Institute and interstate barriers to geographic expansion by commercial banks and by savings and loan associations (S&Ls) have been removed for a large number of states. Remaining barriers have been circumvented in various ways with loan production offices and nonbanking holding company subsidiaries, for example. The Monetary Control Act of 1980 and the Garn-St Germain Act of 1982 essentially allow S&Ls to offer all the financial products and services of commercial banks. Large unregulated diversified nonbank financial companies also now compete aggressively for both loan and deposit customers of banks. In addition, the increasing sophistication and declining cost of computer operations technology have made it possible for financial institutions to compete effectively in a geographic area without an extensive investment in brick-and-mortar offices.

Some observers suggest that these 1980s developments have made local loan and deposit markets more contestable or open to competition, in many states—at the very least in those with liberal interstate branching laws. Thus, they say, branching-related increases in bank deposit concentration are not likely to result in undesirable bank concentration levels, and, hence, should not be viewed as worrisome.

Other experts, however, maintain that potential competition, particularly from nonbank financial firms that are unable to offer the entire cluster of products and services provided by commercial banks, does not yet effectively constrain the behavior of banks operating in any local market. Rather, the number and size distribution of commercial banks operating in that market continue to be the primary determinant of bank conduct and performance, thus making high bank concentration a cause for concern.

In studying this issue, I specifically examined the relationship between the number of commercial banks operating in various markets in Ohio and Pennsylvania and their profitability over various time periods from 1976 to 1985.

If the traditional structure-performance (monopoly) view is correct, the profitability of banks operating in highly concentrated markets should be significantly higher than banks operating in markets with larger numbers of actual competitors. Further, this relationship should remain evident over the entire period being examined. If the contestable market view is correct, however, and potential competition has become an important constraining force, significant differences in profitability should not be apparent for banks operating in markets with different numbers of actual competitors, at least in the later years of the period examined.

The particular banks analyzed were selected in the following way. First, all to be in continuous operation over the three time periods. In each state, a single-market banks headquartered in non-SMSA (standard metropolitan statistical area) counties were included in the sample. Single-market banks are those with all their offices located within the county. The presumption is that non-SMSA counties are generally equivalent in terms of potential and actual competition. Thus, the selection procedure allows the number of actual bank competitors in each of these non-SMSA counties to be determined. Banks in SMSA's in each state were included in the sample if all of their offices were located within the SMSA. If not, then an SMSA was presumed to approximate urban banking markets. The banks selected were classified into one of four categories based on the number of actual bank competitors faced in the market and mean concentration. Three classes were created for rural market banks: 1-3 competing banks, one or more competing banks. All SMSA banks were put into a single class that can be called "a large number of competing banks class."

Annual return on asset figures (net income after taxes before securities transactions divided by average total assets) were obtained for each bank included in the sample, for each year of the 1976-1985 period, and were averaged over roughly three-year subintervals. The mean profit rates should not be apparent. Finally, unlike banks in other regions, the banks in Ohio and Pennsylvania generally have not engaged in a great deal of energy or agricultural lending. As a result, their performance has not been significantly affected by the boom and bust cycles occurring in these two sectors over the past several years. Thus, any relationship between the banks' performance and market structure should be easier to detect.

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Intrastructural and interstate barriers to geographic expansion by commercial banks and by savings and loan associations (S&Ls) have been removed or mitigated in the large number of states. Remaining barriers have been circumvented in various ways (with loan production offices and nonbanking holding company subsidiaries, for example). The Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982 essentially allow S&Ls to offer all the financial products and services of commercial banks, large-scale unregulated diversified nonbank financial companies also now compete aggressively for both loan and deposit customers of banks. In addition, the increasing sophistication and declining cost of computer technologies have made it possible for financial institutions to compete effectively in a geographic area without an extensive investment in brick-and-mortar offices.

Some observers suggest that these 1980s developments have made local loan and deposit markets more contestable and open to competition, in markets at least in those with competitive intrastate branching laws.

Thus, they say, branching-related increases in bank deposit concentration are not likely to result in undesirable bank conduct and performance, and should not be viewed as worrisome.

Other experts, however, maintain that potential competition, particularly from nonbank financial firms that are not subject to branching-related increases in bank deposit concentration, is an important factor in both states, particularly in Ohio. Since the interval of analysis spans the pre- and post-Monetary Control Act and Garn-St. Germain Act periods, the impact of expanded S&L powers on the bank concentration-performance relationship (if any) should be apparent.

Finally, unlike banks in other regions, the banks in Ohio and Pennsylvania generically have not engaged in a great deal of energy or agricultural lending. As a result, their performance may have been affected by the boom and bust cycles occurring in these two sectors over the past several years. Thus, any relationship between the banks' performance and market structure should be easier to detect.

The particular banks analyzed were selected in the following way. First, all banks had to be in continuous operation over the entire period examined. If the market structure viewed is correct, however, and potential competition has become an important constraining force, significant differences in profitability should not be apparent for banks operating in markets with different numbers of actual competitors, at least in the later years of the period examined.

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The Banks and Ohio and Pennsylvania were selected for analysis for several reasons. Most importantly, bank branching laws in both states were liberalized beginning on January 1, 1979 and on March 1, 1980. This change in branching laws allows the relationship between concentration and bank profitability to be examined both before and after this change.

Additionally, S&Ls are an important factor in both states, particularly in Ohio. Since the interval of analysis spans the pre- and post-Monetary Control Act and Garn-St. Germain Act periods, the impact of expanded S&L powers on the bank concentration-performance relationship (if any) should be apparent.

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The banks selected were classified into one of the following categories based on the number of actual bank competitors faces the market and market structure. Three classes were created for rural market banks: 1-3 competing banks, 4-6 competing banks and seven or more competing banks. All S&Ls were put into a single class that can be considered "the market view is correct, however, and potential competition has become an important constraining force, significant differences in profitability should not be apparent for banks operating in markets with different numbers of actual competitors, at least in the later years of the period examined.

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Annual return on asset figures (net income divided by average total assets) were obtained for each bank included in the sample, for each year of the 1976-1985 period, and were averaged over roughly three-year sub-intervals. Significant branches are found only in the earliest time interval (1976-1978) and the middle sub-interval (1980-1982). The particular sub-intervals were chosen by chance, in the first place, and they were limited in both states, and S&Ls had limited asset and liability powers. The second period was a rather turbulent one in which the number of actual competitors increased significantly. Ohio banks were then permitted to branch more freely but the Pennsylvania branching law was not yet changed. S&Ls had been given some additional powers, but they would not receive others until 1982. In the final period, branching was liberalized in Pennsylvania, and S&Ls and banks had essentially the same powers. As banks, thus, the intensity of potential competition presumably increased in each of the three sub-intervals.

Then mean return on assets figures were computed for the banks in each market for each of the three sub-intervals. If the traditional (monopoly) view is correct, and potential competition from bank and nonbank sources has continued to be relatively weak, the mean profit rate should be significantly higher in the highly concentrated rural markets than it is in less concentrated rural markets and S&L's in all of the subintervals examined. It should also be higher in the less concentrated rural markets than it is in the more concentrated ones. On the other hand, if potential competition has become a meaningful force over the period of analysis, significant differences in mean profit rates should not be apparent for banks in the different classes, at least in the most recent interval.

The means and standard deviations of the return on assets figures for the banks in each class over time are presented in Table 1 to 3. Significant differences are detected only in the earliest time interval (1976-1978) and the middle sub-interval (1980-1982). The particular sub-intervals were chosen by chance, in the first place, and they were limited in both states, and S&Ls had limited asset and liability powers. The second period was a rather turbulent one in which the number of actual competitors increased significantly. Ohio banks were then permitted to branch more freely but the Pennsylvania branching law was not yet changed. S&Ls had been given some additional powers, but they would not receive others until 1982. In the final period, branching was liberalized in Pennsylvania, and S&Ls and banks had essentially the same powers. As banks, thus, the intensity of potential competition presumably increased in each of the three sub-intervals.

The findings are consistent with the traditional structural-performance relationship view in all of the three sub-intervals. Thus, the profitability measure excludes gains and losses on securities transactions. It is felt that securities gains in any period will not be significant additives (pairwise t-tests are used), are different figures. Significant branches are found only in the earliest time interval (1976-1978), when the mean return of banks in each market was a rather turbulent period, and was significantly greater than those in each of the other three market types (t-statistics are 2.29, 2.15, and 2.71, respectively). Thus, the Ohio findings indicate that a strong positive relationship between potential competition and banks' performance (monopoly) view is correct, however, and potential competition has become an important constraining force, significant differences in profitability should not be apparent for banks operating in markets with different numbers of actual competitors, at least in the later years of the period examined.

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Summary and Conclusions

The traditional view that high concentration typically results in undesirable conduct and performance (monopolistic behavior) has come under attack in recent years. In essence, proponents cite the constraining influence of potential competitors on the actions of incumbent firms. The view that market structure is a relatively unimportant determinant of firm behavior presupposes that barriers to entry into any market are minimal. Some observers argue that the regulatory and technological changes that have taken place in the financial services industry in recent years have significantly eroded barriers to competition between bank and nonbank financial institutions, making local banking markets contestable. The implication is that high concentration in such markets is unlikely to result in anticompetitive conduct, and so is not a cause for concern. Others maintain that meaningful barriers to entry continue to exist and that substantial increases in concentration should be prevented. The public policy implication of this empirical finding is that mergers and acquisitions that boost concentration to some relatively high level should not be permitted. In essence, this has been the position of the Justice Department and bank regulators. However, recent criticisms of this view have increased in recent years. Economists of the so-called "Chicago School" have argued that insufficient emphasis has been given to the disciplining role of potential competitors. They maintain that monopoly power can only exist and persist when barriers prevent potential competitors from entering a market in response to excessive profits earned by incumbent firms. Chicago School economists cite government regulation and legislation as the sole source of truly effective entry barriers. Contestable market theorists also include the magnitude of sunk costs, that is, unrecoverable fixed costs) necessary for entry into a market. If sunk costs required for entry are low, firms can easily go out of business if they suffer losses. Established firms then cannot use predatory pricing as a weapon to discourage new entrants. Thus, the present threat of entry from new firms effectively constrains the pricing behavior of existing firms. These theorists have demonstrated that if a market is contestable, that is, with low barriers to entry and exit, it is possible to have intense competition, even if the number of actual competitors is quite small, or alternatively, if concentration is high.

The nature of the relationship between the concentration-profitability relationship is consistent with what one would expect to find if banking markets were, in fact, contestable. A significant relationship between market concentration and bank profitability was detected for the sample banks over the 1976-1978 interval, but in no other more recent time period. The disappearance of the relationship coincided with the liberalization of bank branching laws in Ohio and Pennsylvania and the expansion of S&L powers authorized by Congress in 1980 and 1982. The findings imply that merger-related increases in concentration in states with minimal barriers to geographically expanding banks are unlikely to result in monopoly profits for institutions in local markets affected. If such mergers are in fact motivated by a desire to gain efficiencies, preventing them because of their impact on concentration would appear to be costly to society. Mergers that increase concentration might be opposed for a variety of non-economic reasons. However, actual social benefits from preventing these mergers should be balanced against the potential economic efficiency gains that are lost.

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