# EFFECTS OF REGULATION, BRANCHING, AND MERGERS ON BANKING STRUCTURE AND PERFORMANCE: COMMENT*

In the course of a recent article in this *Journal*,[1] Kalman J. Cohen and Samuel Richardson Reid suggest that bankers and bank regulators share an aversion to competition in banking. In their view this anticompetitive bias is manifested in a widespread pro-merger attitude "among legislators and regulatory agencies without any clear-cut demonstrable evidence to support this position. The assumed benefits of bank mergers seem to be almost universally accepted as a fact of economic life" (p. 238). Although some bank merger proposals are motivated at least partly by a desire to limit competition, it should be noted that many bank mergers enhance competition or otherwise benefit the public interest,[2] and that most Federal regulators do not hold such categorical pro-merger views as Cohen and Reid impute to them.

Cohen and Reid claim that "for those who believe in the preservation and promotion of banking alternatives, the future is indeed bleak unless there is legislative and regulatory agency recognition of the problem" (p. 231). It will be argued in this Comment that as a result of legal developments and current regulatory attitudes the situation is not nearly so "bleak" as Cohen and Reid suggest. Prior to passage of the Bank Merger Act of 1960 bank mergers were controlled almost exclusively under state laws, and state banking authorities paid relatively little attention to competitive effects. Under the 1960 law, Federal banking agencies are required to give explicit attention to the competitive factor in their decisions on bank merger proposals.

Cohen and Reid suggest that despite many studies and proposals aimed at promoting competition in banking the bank lobbies scored a victory in obtaining passage of the 1966 amendments to the Bank Merger Act of 1960. They assert that the legislation was designed "primarily to decrease the impact of applying the antitrust laws to bank mergers," to "curb the power of the Antitrust Division...."[3] In the banking literature and in the courts, there has been considerable debate as to the intent of Congress in passing this legislation, i.e., whether Congress meant to mitigate the application of strict antitrust standards to bank mergers. Most commentators agree, with Klebaner, that "the 1966 standards are 'stricter' than 1960's,...the new law emphasizes competitive impact more than the 1960 act."[4] Cohen and Reid arrived at a contrary interpretation through what seems to be a rather slanted reading of the law. I will endeavor to elucidate three points which the authors raise concerning the 1966 law.

(1) The law does in fact provide merging banks with a new antitrust defense. If a proposed merger is found to have substantial anticompetitive effects, it may nonetheless be approved by the responsible agency provided that the "anticompetitive effects of the proposed trans-

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* The opinions expressed in this comment are those of the author and are in no way intended to represent the views of the Federal Reserve System. The author wishes to express his appreciation to Paul M. Metzger for his helpful comments and suggestions on an earlier version of this paper.

[1] "Effects of Regulation, Branching, and Mergers on Banking Structure and Performance," *Southern Economic Journal*, October 1967, pp. 231–249.

[2] See P. M. Horvitz, "The Role of Mergers in Fostering a Viable Banking System," Unpublished paper, November 1966; New York State Banking Dept., *Branch Banking, Bank Mergers, and the Public Interest*, January 1964; and G. W. Mitchell, "Mergers Among Commercial Banks," in A. Phillips (ed.) *Perspectives on Antitrust Policy* (Princeton, N. J.: Princeton University Press, 1965), pp. 225–243.

[3] Their major comments are contained in footnotes 6 and 12.

[4] See B. J. Klebaner, "The Bank Merger Act: Background of the 1966 Version," *Southern Economic Journal*, October 1967, p. 258.

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action are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served." However, the courts have ruled that the burden of proving this "convenience and needs" defense or justification rests with the banks once a merger is challenged by the Justice Department. The courts have generally taken a hard line favoring the government's position against that of the defendant banks, and it appears that the "convenience and needs" defense will be an extremely difficult defense with limited applicability in the courts.[5]

(2) As Cohen and Reid state, "the Attorney General is now limited to only thirty days after the approval of a merger" in which to file suit to stop the merger. On the other side of the coin, the thirty days constitute a required waiting period before a merger may be consummated. Others have noted that this provision—automatic premerger notification and stay of mergers pending opportunity for suit to be brought—is a potent weapon for the government, one which courts have almost uniformly refused to grant in the past.[6] Also, even if Justice fails to sue and the merger is consummated, the banks are *not* immune to future suit under Section 2 of the Sherman Act, which relates to monopolization.

(3) In addition to lamenting banks' immunity under the 30-day "now or never" provision, Cohen and Reid complain that the 1966 legislation would exempt "some . . . (previously completed) mergers from the antitrust laws despite the fact that the courts have held them to be in violation" of the law. In fact, this forgiveness feature only affected directly three cases (then in the courts) involving mergers consummated before the landmark "Philadelphia Case" of June 1963.[7]

In short, the interpretation of the 1966 law which Cohen and Reid present may be challenged on several grounds. After reviewing the act and its implication, Klebaner concluded that "in the provision forgiving defendant banks in the 3 successfully completed cases, the Justice Department lost a battle; in the clear-cut recognition of its authority to challenge agency-approved bank mergers and in the provision for an automatic stay, the Antitrust Division may have won the war."[8] Regarding the 1966 amendments, virtually all other observers have concluded that, as Williams states:[9]

> . . . the banking industry will find it even more difficult to effectuate mergers containing anticompetitive factors and will have gained little by the elimination of the fear of attacks on past mergers. . . . Future anticompetitive bank mergers will have greater difficulty even obtaining bank agency approval.

As a result of the stricter provisions of the new law and generally vigorous enforcement by the courts, there has been a marked reduction in merger applications which raise serious competitive issues.[10] Thus, Lifland notes that "As the Department of Justice and the banking agencies

[5] See J. W. Via, "Antitrust and the Amended Bank Merger and Holding Company Acts: The Search for Standards," *Virginia Law Review,* No. 5, 1967, pp. 1115–1132, and statements by Congressmen Reuss and Patman in the *Congressional Record,* Vol. 112 (February 8, 1966), pp. 2334–2337.

[6] See W. T. Lifland, "The Supreme Court and the Bank Merger Act of 1966," *The Bankers Magazine,* Autumn 1967, p. 21, and L. L. Williams, "Bank Mergers and the Antitrust Laws—Recent Developments," *Antitrust Bulletin,* Summer 1967, p. 443.

[7] *United States* v. *Philadelphia National Bank.* 374 U. S. 321 (1963). In this and subsequent cases the Supreme Court ruled that bank mergers were subject to the standards of the antitrust laws.

[8] Klebaner, *op. cit.,* p. 258.

[9] Williams, *op. cit.,* pp. 442, 444.

[10] See T. Smith, "Bank Merger Policy and the 1966 Amendment," paper presented before a meeting of the Southern Economic Association, Atlanta, Ga., November 11, 1966. A rule laid down in the 1963 Philadelphia case, prohibiting mergers resulting in a bank controlling more than 30% of a given market, has registered a strong deterrent effect on merger applications, as documented by R. A. Hammond, "The Philadelphia National Bank Doctrine—a Verification," address before the American Bar Association, published in the *American Banker,* September 14, 1967, pp. 4ff.

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grow more accustomed to working together, still fewer cases may be brought to court." [11]

The tightening of legislative and judicial standards has surely stimulated an increasingly "hard line" approach by the banking agencies.[12] The agencies' records under the Bank Merger Act have been reviewed by Hall and Phillips, Reycraft, and others.[13] In order to bring the discussion up to date, I will examine briefly the recent rulings of the Federal Reserve Board. The Board approved 21 merger applications in 1966 and denied one. The Justice Department did not bring suit against any of the approvals; it viewed 10 as entirely free of anticompetitive effects and 9 as having some but not serious adverse effects on competition.[14] In its decisions of 1967 through January, 1968, the Board approved 13 applications and denied three. Among the approvals, two cases[15] were judged to involve important anticompetitive effects, but the applications were approved as solutions to serious management or capital problems, in order to avoid possible failure of the acquired banks. In other cases anticompetitive effects were considered absent or negligible; and in several instances involving minor competitive problems the Board recognized significant "convenience and needs" gains in support of the applications. Two of the Board's denials[16] involved banks of such limited size that their mergers would scarcely have been considered objectionable prior to the tightening of policy in recent years.

In view of the courts' and the Justice Department's current "hard line" application of antitrust law to bank mergers and the Federal regulatory agencies' increasing attention to competitive effects involved in merger proposals, the pessimistic view which Cohen and Reid express regarding the future of banking competition seems exaggerated.

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[11] Lifland, *op. cit.*, p. 24.

[12] It is impossible to speak of a single policy on the part of the three Federal agencies which rule on merger cases—the Comptroller of the Currency, the FDIC, and the Federal Reserve Board—since their views have often diverged. Primary responsibility for a given case is assigned to one of the three depending upon characteristics of the resulting bank. In an attempt to achieve a more unified policy, the other two agencies, and the Justice Department as well, are required to submit to the responsible agency reports on "competitive factors" involved in each case.

[13] See G. R. Hall and C. F. Phillips, Jr., *Bank Mergers and the Regulatory Agencies—Application of the Bank Merger Act of 1960* (Washington, D. C.: Board of Governors of the Federal Reserve System, 1964); and G. D. Reycraft, "Bank Merger Compliance with Antitrust Laws," *Antitrust Bulletin*, Summer 1967, pp. 445–471.

[14] Williams, *op. cit.*, p. 444.

[15] "Security Bank and Trust Company," *Federal Reserve Bulletin*, February 1967, pp. 232–234, and "Detroit Bank and Trust Company," *Federal Reserve Bulletin*, October 1967, pp. 1721–1725.

[16] See "Bank of Sussex County," *Federal Reserve Bulletin*, April 1967, pp. 570–572, and "The Citizens Banking Company," *Federal Reserve Bulletin*, January 1968, pp. 82–83, and compare data on mergers denied during 1960–1962 in Hall and Phillips, *op. cit.*

## *EFFECTS OF REGULATION, BRANCHING, AND MERGERS ON BANKING STRUCTURE AND PERFORMANCE: REPLY*

The comment[1] addressed to our October, 1967 article[2] is devoted solely to some remarks contained in the introductory statement of that article. The commentator has attempted to validate his criticisms by using only a minimum of the available data, and his interpretation of that data is questionable. Despite these and other

[1] Steven J. Weiss, "Effects of Regulation, Branching, and Mergers on Banking Structure and Performance: Comment," *Southern Economic Journal*, this issue.

[2] Kalman J. Cohen and Samuel Richardson Reid, "Effects of Regulation, Branching, and Mergers on Banking Structure and Performance," *Southern Economic Journal*, Vol. 34, No. 2, October 1967, pp. 231–249.

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shortcomings, we appreciate his interest in our research and welcome this opportunity to respond and to expand the discussion.

The main thrust of the comment is designed to minimize a "pessimistic" view which we expressed concerning prospects for the promotion and preservation of banking alternatives. Since five of the six quotations from the article were taken out of context, we invite the reader to refer to our original article, particularly the introductory statement (pp. 231–234). This will provide the necessary frame of reference.

In the second paragraph of the comment, the commentator refers to our statement: "For those who believe in the preservation and promotion of banking alternatives, the future is indeed bleak unless there is legislative and regulatory agency recognition of the problem." The particular problem we were referring to was the important influences that state branching laws have upon the magnitude of bank merger activity as well as the amount of new entry in commercial banking. We predicted that banking alternatives (the number of independent commercial banks) would decline in the years ahead unless the banking regulators recognized this association of merging and branching. This prediction was based upon the fact that the vast majority of bank mergers occur in states which permit branch banking, and that the probability is high that branching laws will be liberalized in the future.[3] The commentator overlooked our statements and instead argued that "... as a result of legal developments and current regulatory attitudes the situation is not nearly so 'bleak' as Cohen and Reid suggest." Since the legal developments to which he refers have nothing to do with state branching laws, his analysis has no relevance to the problem we posed. The same situation holds for the current Federal regulatory posture toward bank mergers.

An analysis of the available data concerning bank mergers and bank entry for the period since the passage of the 1966 amendment to the Bank Merger Act reveals that over 90 per cent of the bank mergers involved banks in branching states.[4] At the same time there was less new entry in branching states than in unit states (which are much fewer in number). In addition, the number of commercial banks declined from 14,309 on January 1, 1966 to 13,721 on January 1, 1968 to 13,679 at the end of 1968.

The record indicates that our original observation concerning bank merger and bank entry problems (as they relate to branching states) remains correct. During the past three years, 1966–1968, there have been more bank mergers than new

[3] There are indications that a number of attempts to liberalize branching will be made in the upcoming legislative sessions in several states. An organized attempt is already underway in Indiana to extend branching and promote the creation of larger banking units through mergers. In January, 1969 Governor Hughes of New Jersey signed "... a new state banking law, which gives banks greater leeway in merging and branching ...Bank Analysts say the liberalized banking law will cause a spate of mergers within the state." (*Wall Street Journal*, January 23, 1969, p. 5.)

On pp. 245–246 of our earlier paper, we stated: "If branching is liberalized and the merger alternative encouraged (as in Virginia), one should expect an accelerated pace toward a concentrated banking structure in a state." A recent statement by Governor J. L. Robertson of the Federal Reserve Board (printed on p. 165 of the *Federal Reserve Bulletin* for February, 1969) corroborates our prediction; he said:

> ...I recently noted in a statement of dissent from a Board approval of an additional bank acquisition by an existing bank holding company in Virginia—that from 1966 to 1968 the percentage of deposits in Virginia controlled by bank holding companies had increased from 27 per cent to 37 per cent. The Fidelity-American Bankshares formation will increase this concentration to nearly 42 per cent.

[4] Space limitations prevent our including the underlying data in this "Reply." They are presented in Table 1 of Kalman J. Cohen and Samuel Richardson Reid, "Bank Mergers, Legislation, and the Public Interest," unpublished working paper, April 1969. Interested readers can obtain copies by writing to Professor Kalman J. Cohen, Graduate School of Industrial Administration, Carnegie-Mellon University, Pittsburgh, Pennsylvania 15213.

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bank entrants in states which permit branching by commercial banks. It also appears that, even without significant changes in state laws, independent banking alternatives are declining. It is further distressing to note that this decline is occurring at a time when total bank deposits are expanding at a rapid pace.

When our original statement is put in proper context, the evidence suggests that we were indeed quite correct in our predictions. In the continued absence of recognition of the problem, this situation should persist; consequently the outlook remains bleak for those concerned about the promotion and preservation of independent banking alternatives.

The commentator attempts to give the impression that the banking agencies have become quite strict concerning bank mergers since the 1966 amendment to the Bank Merger Act. The statement is made that "the tightening of legislative and judicial standards has surely stimulated an increasingly 'hard line' approach by the banking agencies." In order to substantiate this observation, he cites the record of only one of the Federal banking agencies, which according to his data approved 34 of the 38 applications in the period 1966 through January 1968. This approval rate of 89.5 per cent is linked with a "... tightening of policy in recent years." In order to determine the significance of the commentator's conclusions on this important aspect of public policy, we have assembled data on bank mergers for each of the Federal regulatory agencies since the passage of the Bank Merger Act of 1960.[5]

An examination of data for the period since passage of the Bank Merger Act of 1960 through 1965 and the period from 1966 to the present for all the Federal agencies presents an interesting picture. During 1966 through 1968 the Comptroller of the Currency approved 261 bank mergers and denied 4 for an approval rate of 98 per cent. Since the passage of the Bank Merger Act in 1960 until the end of 1965, the Comptroller of the Currency approved 500 bank mergers and denied 8 for an approval rate of 98 per cent. The Board of Governors approved 48 of 52 merger applications during the period 1966 through 1968 for an approval rate of 92 per cent. In the earlier 1960–65 period, 156 bank merger applications were approved and 18 were denied by the Board of Governors, for an approval rate of only 90 per cent. The F.D.I.C. approved 143 of 148 merger applications considered for a 97 per cent approval rate during 1966 through 1968. The data for the 1960–65 period reveal that 203 merger applications were approved and only 2 were denied by the F.D.I.C. giving an approval rate of 99 per cent. Thus, it is difficult to isolate any new "hard line" approach related to bank mergers when one observes a continued high level of activity and approval rates for the three Federal regulatory agencies ranging from 92 per cent to 98 per cent in the recent 1966–68 period, not very different from the approval rates for the same agencies from the passage of the Bank Merger Act in 1960 until the end of 1965. The rapid rate of bank mergers, coupled with a sharp decline in new bank entry during the 1966 through 1968 period, has contributed to a decline in the number of commercial banks since the passage in 1966 of legislation amending the bank merger laws. Thus, consideration of all the available evidence casts doubt upon the commentator's claim that the Federal bank regulatory agencies have adopted an increasingly "hard line" approach.

The main opposition to the trend toward more concentrated banking markets since the enactment of the Bank Merger Act of 1960 has come from the courts, which were given the opportunity to ex-

[5] These data are presented in Table 2 of Cohen and Reid, "Bank Mergers, Legislation, and the Public Interest," *op. cit.*

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press their opinions due to the challenges by the Antitrust Division of the Department of Justice of certain approved bank mergers. The permissive attitudes of the Federal banking regulators (who are supposed to protect the public interest) contributed to this development. Hence the public has had to pay not only the costs associated with bank regulation, but also the costs of litigation necessary to provide at least an element of protection from growing concentration in particular banking markets.

While the commentator states that "... it should be noted that many bank mergers enhance competition or otherwise benefit the public interest...," he does not provide us with any significant evidence which supports this position. The basis for this statement is an unpublished paper by Horvitz;[6] a reference to the New York study, where the results can be interpreted in quite the opposite manner;[7] and some very subjective comments by Governor Mitchell in a theoretical paper containing a number of unsupported speculations.[8] In short, the proponents of bank mergers continue to hold their positions and ask for support without supplying any empirical evidence to substantiate this position. Other alternatives are seldom examined or explored in any depth or conviction.[9]

Those familiar with our original article should realize that it was not our intention to make any detailed interpretations of the 1966 amendment to the Bank Merger Act of 1960. The commentator devotes almost half of his space to a discussion of our "interpretation" of the amendment. The quotations from our original article, taken out of context, were originally contained in two footnotes in the introductory statement of the article. Since the commentator has paid so much attention to this point, we will respond with evidence to support our original observations.[10]

At the outset let us correct a misleading statement which the commentator

[6] The Horvitz paper does not contain any empirical evidence and merely restates the familiar regulatory agency position. He contends that mergers are favorable because of the "failing bank" problem and the "need for larger banking institutions." Horvitz, formerly with the Comptroller's Office and currently Director of Research at the F.D.I.C., also disregards the available evidence in speculating that when a unit bank is merged into another bank and becomes a branch, "...it can then be operated at less cost." For evidence to the contrary see George J. Benston, "Branch Banking and Economies of Scale," *Journal of Finance,* Vol. 20, No. 2, May 1965, pp. 312–331. For a more recent study see Frederick W. Bell and Neil B. Murphy, *Economies of Scale in Commercial Banking,* Federal Reserve Bank of Boston, 1967. For another empirical study see Kalman J. Cohen and Samuel Richardson Reid, "The Benefits and Costs of Bank Mergers," *Journal of Financial and Quantitative Analysis*, Vol. 1, No. 4, December 1966, pp. 15–57.

[7] The problem here is an accurate definition of the public interest. The New York study stated: "The major detrimental effects could be higher service charges in special and regular checking accounts of individuals and small businesses." This is the only unique service provided by commercial banks. See *Branch Banking, Bank Mergers, and the Public Interest: A Summary Report,* New York State Banking Department, January 1964, p. 34. In addition, Horvitz and Shull studied the policy changes of banks after a merger. They reported that in "12 of these cases the changes resulted in a net reduction in the monthly service charges, while in 26 there were net increases." They further stated that "in only two out of 16 was there a net decrease in the cost of maintaining a special checking account at the office of the acquired bank." See Paul M. Horvitz and Bernard Shull, "The Impact of Branch Banking on Bank Performance," *National Banking Review,* Vol. 2, December 1964, p. 160.

[8] No data (or indeed empirical research of any type) are presented in the Mitchell paper. Subsequent research casts doubt upon the validity of the assumptions and conclusions presented. To his credit, Governor Mitchell does recognize the uniqueness of demand deposits as a service of commercial banks.

[9] A number of alternative solutions to banking problems are available. For some examples, see Chapter 12 in Samuel Richardson Reid, *Mergers, Managers, and the Economy,* New York: McGraw-Hill Book Co., 1968.

[10] Unfortunately our detailed review of the available evidence could not be included in this "Reply" because of space limitations. A more extended discussion is contained in Section III of Cohen and Reid, "Bank Mergers, Legislation, and the Public Interest," *op. cit.*

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makes regarding responsibility for regulatory decisions concerning bank mergers prior to the passage of the Bank Merger Act of 1960. He states that "...bank mergers were controlled almost exclusively under state laws, and state banking authorities paid relatively little attention to competitive effects." The commentator neglects to mention that prior to the 1960 Act, mergers involving national banks had to be approved by a Federal regulator, the Comptroller of the Currency. During the 1950–60 period, this Federal regulatory agency approved 904 mergers and the various state agencies approved 735 mergers.[11]

The commentator attempted to "... elucidate three points which the authors raise concerning the 1966 law," and we shall comment on each point raised. The first point relates to the new antitrust defense provided merging banks. It remains unclear to us why banks should be given this special exception. In essence, this provision permits a bank merger even though it may have serious anticompetitive effects if it can be shown that these effects are clearly outweighed in the public interest by the probable effect of the merger in meeting the "convenience and needs" of the community. This provision appears to be a paradox, since one would expect a competitive market to be meeting the "convenience and needs" of the community. The fact that the courts expect the banks to *justify* this defense appears logical. The fact that they can *make* this defense under the new law appears curious.

The second point has to do with the time restriction placed upon the Antitrust Division by the legislation. The merger must be challenged within thirty days; if not, it is immune from future litigation under Section 1 of the Sherman Act and Section 7 of the Clayton Act. This provision clearly creates a preferred position for bankers, and while they can conceivably still be tried for monopolization violations (under Section 2 of the Sherman Act), this was clearly a major concession to a powerful lobby which originally sought complete immunization from the antitrust laws. In addition, the thirty-day waiting period may also be viewed as a benefit to the bankers involved since they have complained so vigorously about the difficulties of unscrambling merged banks.

The third point raised by the commentator is related to a most unique provision which was incorporated as part of the 1966 amendment and which has important implications. In addition to granting immunization to all previously consummated mergers (except for possible monopolization charges), the legislative branch of government overruled the judiciary, including the highest court in the land. The fact that this special exemption "only affected directly three cases" (as noted by the commentator) is far less important than the general principle and precedent involved, especially at a time when respect for law and maintenance of an independent judiciary system are vital national issues.

In conclusion, we feel the evidence indicates that our concern for the development of a competitive banking structure operating in the public interest was not an "exaggerated" but a realistic approach to the problem. The type of competition we are most concerned about is *price* competition for the only *unique* services which commercial banks offer to the public—demand deposits and small business loans. The real "convenience and needs" of the public will be served when the regulatory agencies recognize the problem and begin to make decisions designed to deconcentrate this basically oligopolistic industry. We hope that in the future the regulatory agencies will align themselves more with the public and less with bank management groups. Protecting the public involves not

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[11] See the 98th Annual Report of the Comptroller of the Currency, 1960, p. 16.

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only providing adequate safeguards for deposits but also safeguards on the various service charges, principally by the provision of numerous competitive alternatives rather than by price controls *per se*. If protection is not forthcoming soon, new legislation will be necessary. The bank merger problem is clearly related to branching activities.[12] Again, we emphasize the unique opportunity that exists for action at the state level which seldom presents itself in a period of growing central government.

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[12] With regard to future developments in the structure of banking, it is difficult to predict how, if at all, the recent proliferation of one-bank holding companies will alter the established pattern of horizontal mergers among banks.

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