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## Interstate Bank Mergers and Competition in Banking

*Paul Calem*

## Efficient Production of Financial Services: Scale and Scope Economies

*Loretta J. Mester*



# BUSINESS REVIEW

Federal Reserve Bank of Philadelphia  
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Over half the states of the nation, including Pennsylvania and New Jersey, have passed laws that open their doors to interstate banking. For both consumers and bankers this is a time of adjustment, excitement, and, perhaps, some concern. The concern centers on competition. Will home-state banks be gobbled up by giant banks from out-of-state? Will the interests of the communities and the small depositors and savers still be served? Each article in this issue of the *Business Review* addresses these kinds of questions, but from different viewpoints.

Paul Calem, in "Interstate Bank Mergers and Competition in Banking," describes and analyzes the elements that help regulators and others estimate how competitive a local or national banking market is. Competitiveness is no longer largely a matter of how many players are in a market and how big they may be. With interstate banking, the potential for many new competitors to get into the market serves to increase competition, as does the opportunity to merge institutions to increase efficiency.

In "Efficient Production of Financial Services: Scale and Scope Economies," Loretta Mester analyzes the latest research on the most efficient size (scale) of financial institutions, as well as the most efficient mix of products (scope) they should offer. Earlier studies found that larger firms have a substantial competitive advantage in terms of costs; but these studies treated financial services as a single product. The most recent literature accounts for the multiplicity of products these firms produce, and finds very little evidence of either a size advantage or a product mix advantage.

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twelve regional banks located around the nation as well as the Board of Governors in Washington. The Federal Reserve System was established by Congress in 1913 primarily to manage the nation's monetary affairs. Supporting functions include clearing checks, providing coin and currency to the banking system, acting as banker for the Federal government, supervising commercial banks, and enforcing consumer credit protection laws. In keeping with the Federal Reserve Act, the System is an agency of the Congress, independent administratively of the Executive Branch, and insulated from partisan political pressures. The Federal Reserve is self-supporting and regularly makes payments to the United States Treasury from its operating surpluses.

# Interstate Bank Mergers and Competition in Banking

*Paul Calem\**

The interstate banking era is well under way, and the days when out-of-state banking firms cannot acquire or merge with in-state firms appear to be numbered. Only a small minority of states have yet to pass interstate banking laws. In the Third Federal Reserve District, interstate banking became a reality with the passage of legislation by New Jersey and Pennsylvania in 1986. As a

consequence, numerous interstate mergers and acquisitions have already taken place, and many more transactions are currently pending.

It is safe to predict that a continuing wave of mergers and acquisitions will bring about consolidation in the banking industry, and there will be fewer and larger banks. But how will banking services ultimately be affected? Will all this activity lead to substantially reduced competition in banking? Will commercial and retail customers be left with too few alternatives at noncompetitive prices?

In fact, just the opposite is likely to happen.

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For one thing, banking regulators will continue to guard against mergers and acquisitions that would substantially reduce competition in local banking markets. And although the market for certain banking products is national, it is unlikely that increasing nationwide consolidation in banking will have significant anticompetitive effects.

At the same time, the institutions that result from interstate mergers or acquisitions may find that because they are larger, they will be able to offer more services or provide existing services more efficiently. As a result, such institutions would be more effective competitors in their markets than the original, smaller firms.

Of equal importance in promoting competition will be the increase in the number of potential entrants into local banking markets—the more competitors who enter a banking market, the greater the competition, which translates into lower charges and better services for consumers. Entry might occur in a number of ways depending, of course, on what each state allows in its law. A new competitor may enter and gain a major share of a market; an out-of-state bank holding company may set up (or acquire) a small bank with only a minor presence in a market (so-called toehold entry); or an in-state nonbanking subsidiary of a bank holding company, such as a consumer finance or trust subsidiary, may expand its operations to provide full-service banking.

These factors will contribute towards a more competitive environment in local banking markets. Thus, given the current regulatory framework, interstate banking is more likely to enhance competition than not, which means that customers will get improved banking services at competitive prices.

#### THE STATUS OF INTERSTATE BANKING

**In the Nation.** In the last few years, state after state has opened its borders to interstate banking, and in 1986 a flurry of interstate activity took place. Several types of interstate banking laws have emerged, reflecting varying entry requirements from state to state.

The most liberal interstate banking laws are the *nationwide* laws, which allow entry by banking organizations from any state in the nation. There are five states with such a law: Alaska, Arizona, Maine, Oklahoma, and Texas. Somewhat less liberal than such laws are the *nationwide reciprocal* laws. These laws allow banking organizations from any state to acquire in-state banks, contingent on reciprocity. That is, an out-of-state organization can merge with or acquire an organization in the host state only if the acquirer's home state grants similar privileges to banking organizations in the host state. Four states have nationwide reciprocal laws: Kentucky, New York, Washington, and West Virginia.<sup>1</sup>

Another category of interstate banking laws includes the *specialized laws*. These laws authorize some specialized form of entry by out-of-state holding companies. This category includes the so-called "limited purpose laws," which generally prohibit entering out-of-state banks from competing with host-state organizations for retail customers. Such laws are usually intended to encourage out-of-state banks to establish special purpose facilities, such as credit card operations. Also included are "troubled institution laws," which authorize the acquisition of troubled or failing institutions within the state.<sup>2</sup> The last category includes the most common interstate banking laws, the *regional* laws. These laws allow only those organizations that are headquartered in a state within a specified region to acquire a

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<sup>1</sup>Under Oklahoma's nationwide law, further in-state expansion of a bank acquired by an institution from a non-reciprocating state is barred for four years subsequent to the acquisition. According to the Texas law, out-of-state organizations will not be permitted to control more than a total of 25 percent of the aggregate deposits in Texas banks.

<sup>2</sup>States having limited purpose laws include Delaware, Maryland, Nebraska, Nevada, South Dakota, Virginia, and West Virginia. States having troubled institution laws include Illinois, New Mexico, Ohio, Oklahoma, Oregon, Utah, and Washington. (Note that many of these states also have a regional or a nationwide reciprocal law.) In addition, many states have so-called "grandfather" laws, which permit out-of-state banking organizations to expand previously existing operations.

bank or bank holding company located in the host state. Of the 28 states having such a law, all but one state (Oregon) make interstate transactions contingent on reciprocity.

Some of the laws that have been passed do not become effective until 1987 or 1988. Also, some of the regional laws include a "nationwide trigger" date, at which time the regional restriction will be eliminated. The overall effect of the diversity of interstate banking laws is that the barriers to interstate expansion are being removed rather unsystematically. But because the majority of laws are regional laws, the removal of these barriers is mainly occurring at the regional level. And roughly speaking, it is possible to delineate several regions within which the barriers to interstate banking will have been largely removed by the end of 1987. (See REGIONS WHERE INTERSTATE ACTIVITY IS LIKELY TO OCCUR, p. 6.)

With the passage of interstate banking laws, numerous mergers and acquisitions are now occurring as bank holding companies move into new states. As of early October 1986, a total of 98 interstate transactions had been approved by the Federal Reserve Board, and at least 96 deals were pending. Especially active in 1986 was the Midwest region, where interstate banking laws were passed in late 1985.

The pace of interstate banking activity is likely to quicken still further in the near future. Oklahoma's nationwide law and Washington's nationwide reciprocal law will both take effect on July 1, 1987. Texas's nationwide law will take effect on January 1, 1987, and West Virginia's nationwide reciprocal law will take effect on January 1, 1988. In addition, various regional laws become effective in 1987 and 1988. And some states still without interstate banking laws may yet pass such legislation. Also, between 1987 and 1989, various states' nationwide triggers will become effective. This not only will increase the volume of interstate activity, but it also will permit more transactions involving widely separated states.

**In the Third District.** The "First State," Delaware, was in fact the first state in the District

to pass a type of interstate banking law. Known as the Financial Center Development Act, Delaware's limited purpose law permits out-of-state bank holding companies to establish "de novo," or new, subsidiaries, provided they meet certain capital and employment conditions, limit operations to a single location, and do not compete with Delaware-based banks for retail customers. Currently, at least 24 bank holding companies from other states, including many organizations based in New York City, have taken advantage of the Delaware law to set up credit card, wholesale lending, cash management, and other operations.<sup>3</sup>

In 1986, New Jersey and Pennsylvania each passed regional reciprocal laws. Pennsylvania's interstate banking bill was signed on June 25, 1986, and became effective on August 25. It grants reciprocity to New Jersey, Kentucky, Ohio, and several states in the east. New Jersey's law, passed in March, 1986, also became effective on August 25. It grants reciprocity to Pennsylvania, to the same states as does Pennsylvania's law, as well as to several states in the midwest. (For more details, see NEW JERSEY AND PENNSYLVANIA GO INTERSTATE, p. 14.)

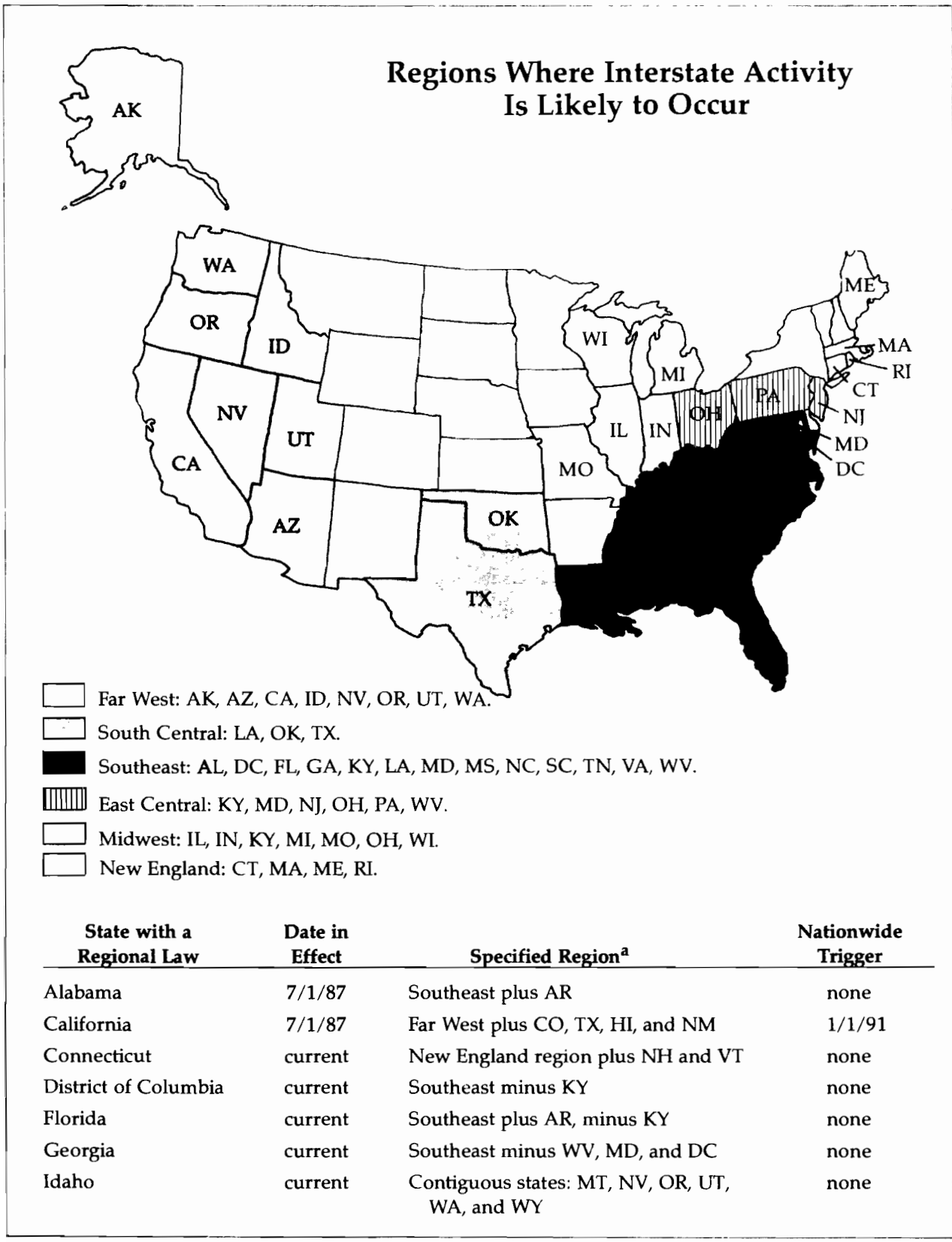
Interstate activity in New Jersey and Pennsylvania is already underway. At least three interstate transactions have been approved or are currently pending between New Jersey and Pennsylvania banking organizations. In addition, some transactions are pending between Pennsylvania banking organizations and organizations in Ohio and Kentucky.

#### **WILL COMPETITION BE KEENER IN LOCAL BANKING MARKETS?**

As interstate banking legislation is passed, the urge to merge seems to be an inevitable accompaniment. When the trigger is pulled for national

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<sup>3</sup>For a more detailed discussion of Delaware's law, see Janice Moulton, "Delaware Moves Toward Interstate Banking: A Look at the FCDA," this *Business Review* (July-August 1983) pp. 17-25.



State with a Regional Law	Date in Effect	Specified Region <sup>a</sup>	Nationwide Trigger
Illinois	current	Contiguous states: IN, IA, KY, MI, MO, and WI	none
Indiana	current	Midwest minus MO and WI	none
Louisiana	7/1/87	Southeast plus AR, OK, and TX	1/1/89
Maryland <sup>b</sup>	7/1/87	Southeast plus AR, DE, and PA	6/30/88
Massachusetts	current	New England region plus NH and VT	none
Michigan	current	Midwest minus KY and MO, plus MN	10/10/88
Minnesota	current	Contiguous states: IA, ND, SD, and WI	none
Mississippi <sup>c</sup>	7/1/90	Southeast plus AR, MO, and TX, minus MD and DC	none
Missouri	current	Contiguous states: AR, IL, IA, KS, KY, NE, OK, and TN	none
Nevada <sup>d</sup>	current	Far West minus CA, plus CO, HI, MT, NM, and WY	1/1/89
New Jersey	current	East Central and Midwest, plus DE, VA, TN, and DC	7/1/88 (expected)
N. Carolina	current	Southeast plus AR	none
Ohio	current	East Central and Midwest, plus DE, VA, TN, and DC	10/16/88
Oregon	current	Far West plus HI	none
Pennsylvania	current	East Central plus DE, VA, and DC	3/4/90
Rhode Island	current	New England region plus NH and VT	7/1/88
S. Carolina	current	Southeast plus AR	none
Tennessee	current	Southeast plus AR, IN and MO, minus MD and DC	none
Utah <sup>e</sup>	current	Far West minus CA, plus CO, HI, MT, NM, and WY	12/31/87
Virginia	current	Southeast plus AR	none
Wisconsin	1/1/87	Midwest plus IA and MN	none

<sup>a</sup>For an explanation of the terms East Central, Midwest, Southeast, Far West, and New England region, see the accompanying map. Note that several regions overlap.

<sup>b</sup>Maryland's reciprocity law became effective in 1985 for a subregion consisting of Delaware, Virginia, West Virginia, and the District of Columbia. Maryland's nationwide trigger in effect calls for the removal of most of the restrictions inherent in the state's limited purpose law.

<sup>c</sup>Mississippi's law extends reciprocity to contiguous states effective 7/1/88.

<sup>d</sup>The reciprocity requirement in Nevada's law will be dropped on 1/1/89.

<sup>e</sup>Utah's reciprocity requirement will be dropped on 12/31/87.

reciprocity in a number of states, and when more states pass interstate banking laws, the Federal Reserve System and other federal regulators will be even busier than they are now, assessing the competitive effects of proposed mergers.<sup>4</sup>

Bank regulators are primarily concerned with competition in *local* banking markets. This is because the geographic markets for retail deposits and many other bank products tend to be local. Moreover, unless a specific product market is being examined, such as the market for large certificates of deposit, regulators view banks as providing a single composite product or cluster of services to its customers. A bank's total deposits (excluding the deposits of foreign institutions) is taken to be representative of the amount of services the bank provides. The locality within which banks respond to the pricing of one another's services is considered to be the banking market.<sup>5</sup>

Regulators will continue to guard against mergers that are likely to harm competition in local markets. As a result, local banking markets that are competitive will remain so, even though the structure of the banking industry is being transformed by interstate banking.

**Measuring Concentration in Local Markets.** To assess the effects of interstate mergers on competition, the Fed first examines the effects on banking market concentration. By definition,

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<sup>4</sup>The Federal Reserve regulates bank holding companies and state banks that are members of the Federal Reserve System. The Comptroller of the Currency regulates national banks, and the Federal Deposit Insurance Corporation regulates state nonmember banks. These regulatory agencies evaluate proposed mergers and acquisitions, and they have the authority to block transactions that are determined to be anticompetitive. In addition, the Department of Justice may challenge any bank merger or acquisition it determines to be anticompetitive, although that rarely occurs, because the banking agencies follow policies consistent with the Justice Department guidelines in evaluating the competitive effects of mergers.

<sup>5</sup>The size of a banking market depends upon several factors, such as local commuting patterns, which determine the degree to which banks interact.

the greater the number of banks in a market, and the more equally divided their market shares, the less concentrated that market will be. Generally speaking, a less concentrated market is more conducive to competition. In an unconcentrated market, there will be many reliable sources of banking services, each readily available to customers. Therefore, when a market is not concentrated, banks must remain competitive in order to continue to attract customers. Only in a highly concentrated market could banks have *monopoly* power—the ability to behave noncompetitively by charging higher prices for their services. Thus, substantial increases in concentration in a banking market could signal a significant reduction in competition.

Concentration is measured by looking at each bank's market share. One measure that is often employed is the three-firm or four-firm concentration ratio. This is simply the aggregate market share of the three or four largest firms in a market. For example, if the three largest banks in a banking market control 30, 25, and 20 percent, respectively, of total market deposits, then the three-firm concentration ratio is 75 percent, indicating a concentrated market. Another concentration measure commonly used is the Herfindahl-Hirschman index (HHI). This index is simply the sum of squares of the market shares of each of the firms competing in a given market. Consider once again the preceding example. If the remaining 25 percent of the market in this example were evenly divided among five firms, then the HHI would equal  $(30)^2 + (25)^2 + (20)^2 + 5(5)^2 = 2050$ . Or, if the remaining 25 percent belonged to a single firm, then the HHI would equal  $(30)^2 + 2(25)^2 + (20)^2 = 2550$ . Generally, the fewer the number of firms in a market, and the more uneven their market shares, the higher the HHI.

The Federal Reserve Board applies Department of Justice merger guidelines in analyzing the competitive effects of a proposed merger. Specifically, if a proposed merger would increase the HHI in a market by more than 200, and lead to a post-merger HHI greater than 1800, then the



Federal Reserve Board considers the possibility that the merger might be anticompetitive. In such cases, the Board decides whether other factors outweigh the anticipated increase in concentration; if they do not, the merger is not allowed to take place. Factors that may be taken into consideration can include, for example, competition from thrifts or other nonbank financial firms, or poor financial condition of the institution being acquired.<sup>6</sup>

**Procompetitive Effects.** While the regulatory process generally will prevent anticompetitive interstate mergers from taking place, interstate banking will often have procompetitive effects on local markets. In some cases, interstate mergers may result in more efficient institutions and, hence, in more effective competitors. In other cases, competition in a market may be enhanced by the entry of an out-of-state institution, or by the expansion of an existing nonbanking subsidiary of an out-of-state bank holding company.

Acquisition of a bank by an out-of-state holding company (or a merger involving the bank) may enable that bank to operate more efficiently, for a number of reasons. An acquirer may introduce new management procedures that reduce operating costs. Or it may share valuable information with the acquiree, such as expertise in certain types of lending. Merger or acquisition may also be a cost-effective way for a bank to expand into new lines of business; one merger partner might be providing products and services that the other partner wishes to make available to its customers.

Moreover, in some cases a merger may enable the combined organization to achieve scale or scope economies, although empirical economic research has not found much evidence to sup-

port the view that such economies are typical.<sup>7</sup> *Scale economies* are cost savings or efficiencies that result when two merging organizations consolidate their basic operations. For example, the partners to a merger may be able to reduce their overhead costs by combining their data processing operations at a single location. Or, because a merger results in a larger management pool, each manager may be able to oversee fewer areas of operation. More effective management can result, contributing to increased operating efficiency. Similarly, *scope economies* are cost savings that result from combining different types of financial services and activities within a single organization, which allow resources to be shared and duplication of effort to be reduced. For example, a banking organization which offers discount brokerage services can advertise these services to its depositors when mailing monthly account statements. Thus, the organization can save on advertising costs. Although bank mergers will not in general result in economies of scale or scope, some mergers may indeed yield such cost savings.

Finally, an interstate bank merger may benefit the parties involved by diversifying their risk exposure. Because the combined organization will gather deposits from a wider geographic area, deposit outflows in one market are more likely to be balanced by deposit inflows in another market, thus reducing the organization's exposure to deposit fluctuations. And on the asset side, interstate expansion may enable an organization to diversify its loan portfolio further. By reducing the degree to which its loans are concentrated within a particular industry or geographic area, an organization can reduce its vulnerability to economic downturns in that particular area.

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<sup>6</sup>For a fuller discussion of the factors the Federal Reserve Board might take into consideration, see Jan Loeys, "Bank Acquisitions: The Mitigating Factors Defense," *The Banking Law Journal* (Sept./Oct. 1986) pp. 427-449.

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<sup>7</sup>For a more detailed discussion of scale and scope economies in banking, see the studies cited in Loretta Mester, "Efficient Production of Financial Services: Scale and Scope Economies," this *Business Review*.

Each of these efficiencies that may result from a merger or acquisition would enable a merger partner to offer improved services or lower costs to its customers, and thus to be a more competitive institution. And there are at least two more ways in which interstate banking may enhance competition in local banking markets.

First, with the advent of interstate banking, many large bank holding companies may become competitors in markets outside of their home state. In many cases, they will do so via toehold entry, establishing a small, "fringe" presence in these markets. Where permissible, toehold entry may be accomplished *de novo*, (that is, by creating a new subsidiary), or by converting an existing nonbanking subsidiary into a bank. Otherwise, it may be accomplished by purchasing an existing small bank. The fringe firm thus created can have substantial ability to expand over time, because it is backed by a large holding company. That is, because of the financial support as well as the technical assistance and expertise the parent holding company can provide, the fringe firm has the *potential* to increase its deposit share and become a major player in its market. Therefore, the new fringe competitor may exert a competitive influence greater than its market share would indicate.<sup>8</sup>

Second, the nonbanking interstate subsidiaries of bank holding companies could have a special kind of procompetitive effect on local banking markets. Many large bank holding companies currently operate numerous nonbanking subsidiaries in markets outside of their home state.

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<sup>8</sup>The potential procompetitive effects of toehold entry are well recognized in the economics literature. See, for instance, F. M. Scherer, *Industrial Market Structure and Economic Performance*, Boston, Houghton Mifflin Company (1980) p. 248. Evidence indicates that toehold entry into banking markets can (but not always will) have a deconcentrating effect in the long run. That such entry can be procompetitive is supported by John T. Rose and Donald T. Savage in their study "Bank Holding Company De Novo Entry and Banking Market Deconcentration," *Journal of Bank Research* (Summer, 1982) pp. 96-100.

For example, several out-of-state holding companies operate mortgage banking, consumer lending, commercial lending, as well as leasing subsidiaries in Pennsylvania. (See "OUT-OF-STATE NONBANKING SUBSIDIARIES IN PENNSYLVANIA".) Similarly, several Pennsylvania bank holding companies have a nonbanking presence in numerous other states.<sup>9</sup> When a bank holding company operates such an out-of-state subsidiary, providing a limited number of financial products and services, the holding company (unless prohibited by state law) can enter into other banking activities in the subsidiary's market by expanding the scope of the subsidiary's operations. This often may be easy to accomplish as the legal barriers to such interstate expansion are removed.<sup>10</sup> For example, consider an out-of-state holding company that operates a commercial finance subsidiary in a local market. The removal of barriers to interstate banking may enable the finance subsidiary to gather deposits, including demand deposits, for a bank affiliate. Thus, the holding company could easily become an entrant into the deposit-taking side of the market. The threat of such entry could limit the monopoly power of banks in a

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<sup>9</sup>For example, Corestates Financial Corporation (Philadelphia) operates Signal Financial Corporation, a consumer finance subsidiary with offices in several states on the east coast. And Mellon Bank Corporation (Pittsburgh) operates Mellon Financial Services Corporation, a factoring, commercial and consumer lending, and leasing subsidiary, with offices in major cities nationwide. Meridian Bancorp, Inc., (Reading), operates Meridian Mortgage Corporation, a mortgage and commercial lending subsidiary with offices in Pennsylvania, New Jersey, Delaware, and Florida.

<sup>10</sup>In contrast, expansion into a market by a banking organization not previously present in the market would be time-consuming and difficult, due to various regulatory, technological, and physical impediments. In the language of economics, because of the existence of such impediments, banking markets are not "contestable." (In a contestable market, entry is almost costless, and established firms are induced to keep prices as low as possible so that they will not be displaced by entrants.) For a discussion of the various impediments to entry into banking markets, see Paul Calem and Janice Moulton, "Evaluating the Competitive Effects of Mergers Under Interstate Banking," Working Paper forthcoming, Federal Reserve Bank of Philadelphia, pp. 18-20.

### Out-of-State Nonbanking Subsidiaries in Pennsylvania

The following is a partial listing of the out-of-state bank holding companies having a nonbanking presence in Pennsylvania, and the types of subsidiaries they own.

<b>Holding Company</b>	<b>Mortgage Banking</b>	<b>Consumer Lending</b>	<b>Commercial Lending</b>	<b>Leasing</b>	<b>Representative Offices</b>
Fleet Financial Group - Rhode Island	✓	✓	✓	✓	
Chase Manhattan Corp. - New York	✓		✓		✓
First Maryland Bancorp. - Maryland	✓		✓		✓
Security Pacific Corp. - California	✓	✓	✓	✓	
BankAmerica Corp. - California	✓	✓	✓		
Manufacturers Hanover Corp. - New York	✓	✓	✓		
NorWest Corp. - Minnesota	✓		✓		
Beneficial Corp. - Delaware		✓			
BarclaysAmerican Corp. - North Carolina			✓		
Bank of Boston Corp. - Massachusetts			✓		
Citicorp - New York			✓	✓	
First Interstate Bancorp - California			✓	✓	
Marine Midland Banks, Inc. - New York			✓		✓
Midlantic Banks - New Jersey					✓

concentrated banking market. It might not be worthwhile for those banks to maintain monopoly prices for their services, because that could induce the potential entrant to become a more active competitor in the market.

#### INTERSTATE BANKING AND COMPETITION IN REGIONAL MARKETS

Whereas local banking markets typically encompass a metropolitan area or rural county, the markets for some specific bank products may comprise a region consisting of several states or even, in some cases, the entire nation. In regional markets, banks compete for large or medium-sized corporate customers, engage in syndicated lending to corporations and governments, underwrite or deal in government securities and money market instruments, act as correspondent banks, and engage in such nonbanking activities as data processing and leasing. As the barriers to interstate banking fall, and the banking industry consolidates regionally and nationally, concentration in these markets is increasing. What effect will this have on competition in these markets?

In regional banking markets, a variety of factors affecting competition come into play. On balance, it appears very unlikely that consolidation in these markets will have anticompetitive effects. First, in terms of deposit shares, the banking industry is currently quite unconcentrated nationwide. The four-firm concentration ratio for the banking industry nationally is only 5.8 percent. Moreover, the share of domestic deposits of the top ten firms is only 10.4 percent, and that of the top fifty only 37.9 percent. Although these figures cannot be equated with the level of concentration in specific bank product markets, concentration in regional product markets tends to reflect these low levels. Increases in concentration that are large enough to be a matter of concern are not likely to happen as interstate mergers occur. For instance, according to a recent survey, the top ten correspondent banks nationwide hold less than 28 percent of total domestic correspondent balances.<sup>11</sup> In a region consist-

ing of the Second and Third Federal Reserve Districts (New York, New Jersey, Delaware, eastern Pennsylvania, and southern Connecticut), the four-firm concentration ratio in correspondent banking is about 54 percent.

Second, nonbank financial firms, nonbank subsidiaries of out-of-market banks, and foreign banks provide a substantial degree of competition in many of these regional banking markets. This acts as a mitigating factor, limiting the anti-competitive effects of increasing concentration. For instance, in lending to middle market businesses (businesses that are too large to be considered small businesses, but that are not major national or multinational corporations), regional banks generally compete with the commercial loan subsidiaries of money center banks, foreign banks, and other nonbank financial institutions. And since instruments such as commercial paper and publicly issued bonds can be substitutes for commercial bank loans, banks compete with investment banking firms in the market for large corporate customers. Competition from securities firms is also significant in Treasury bill dealing and municipal bond underwriting. And banking organizations that offer data processing services must compete with many large nonbanking firms such as NCR.<sup>12</sup>

Third, the Federal Reserve System, in evaluating the competitive effects of proposed mergers or acquisitions, considers in particular the nonbanking subsidiaries of the merging organizations. A proposed merger that would substantially reduce competition in some nonbanking activity (an unlikely occurrence to begin with) would face a possible denial or forced divestiture.

The last kind of procompetitive factor to mention here involves customer bargaining power.

<sup>11</sup>See "1984 Correspondent Banking Survey," *American Banker* (November 30, 1984) pp. 27-33, and (March 18, 1985) pp. 26-35.

<sup>12</sup>For a listing of the largest providers of data processing services to financial institutions, see *Savings Institutions*, Special Supplement (September 1984) pp. 43-44.

It is difficult for a bank to behave noncompetitively in dealing with high volume, sophisticated customers, even in a concentrated market. If a bank were to raise its fees too high, these customers could threaten to take their business to a major competitor or to a fringe competitor of the bank, or to withdraw from the market completely, and the loss of such a customer could have a significant impact on bank earnings. Large borrowers, whether middle market businesses or larger corporations, as well as local government bond issuers, may often have bargaining power. This factor also mitigates the effect of increasing concentration in regional markets.

### CONCLUSION

Interstate bank mergers and acquisitions are already commonplace events in some parts of the country, and within a few years they are likely to become common occurrences nationwide. Although regional and nationwide concentration in banking will increase as a result, competition in banking is likely to remain vigorous. The current regulatory framework prevents mergers that would substantially reduce competition in local markets. And regional and national markets, which are generally unconcentrated to begin with, are likely to remain competitive. Various factors, such as competition from nonbank financial firms, will mitigate the effects of increasing concentration in those markets.

Of course, while competition will probably be strong, there exists some concern that interstate banking will have undesirable consequences on other fronts. For instance, it is feared that a banking industry that is highly concentrated nationwide (or within a particular state) might wield too much political clout. Also, banks will grow in size due to mergers and acquisitions. This increasing size of banks may be viewed as a threat to the safety and soundness of the banking system,

on the grounds that the failure of a very large bank could have a serious impact on the financial sector and other sectors of the economy. Further, many small community banks may be acquired by large organizations, and it is feared that these organizations will take away local control from the community banks and will be less apt to support the local economies.<sup>13</sup> These are issues that legislators and regulators will address as need be.

At the same time, the need for restrictions on interstate banking should not be exaggerated, because such restrictions would place a limitation on competition in banking. In many local markets, competition is actually being enhanced as a result of interstate banking. Local markets are experiencing entry by new competitors that are subsidiaries of out-of-state holding companies, including "fringe" competitors. In addition, nonbanking interstate subsidiaries of bank holding companies are becoming potential entrants into full service banking, and as such may be exerting a greater competitive influence on local markets. Competition in a local market is also enhanced when the acquisition of a bank in the market transforms that bank into a more efficient, more dynamic institution. So on balance, bank customers will reap the benefits of more and better bank services at competitive prices as banks expand interstate.

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<sup>13</sup>It is likely, however, that many small banks will survive, unscathed by the new interstate banking environment. In fact, a body of evidence indicates that community banks will by no means disappear. See, for instance, Dave Phillis and Christine Pavel, "Interstate Banking Game Plans: Implications for the Midwest," *Federal Reserve Bank of Chicago Economic Perspectives* (March/April 1986) pp. 23-39, or Dean F. Amel and Donald T. Savage, "The Structural Effects of Interstate Banking: Evidence from Changes in State Banking Laws," draft, (1986) Board of Governors of the Federal Reserve System.

## New Jersey and Pennsylvania Go Interstate

New Jersey's interstate bill establishes an interstate banking region comprising Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, Missouri, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia, Wisconsin, and the District of Columbia. To be eligible to enter New Jersey, bank holding companies must have at least 75 percent of their total domestic deposits within the region; this restriction prohibits leapfrogging, that is, entry into New Jersey by a bank holding company from outside the region that has established a small presence in some state in the region. The law originally required that New Jersey banking organizations be allowed reciprocal entry into at least three states in the region (other than West Virginia or Delaware) before New Jersey extended reciprocity to any state in the region. As Ohio, Kentucky, and Pennsylvania have offered reciprocity to New Jersey, the law is now effective.

The New Jersey law also contains a trigger to nationwide reciprocity. The law will extend nationwide when at least ten more states allow bank holding companies located in New Jersey to acquire bank holding companies or banks located in those states; four of those states must be among the ten largest, by total commercial deposits, in the country. It appears that New Jersey's trigger date for nationwide reciprocity will fall on July 1, 1988, given the current status of interstate legislation.

Pennsylvania's interstate banking bill establishes an interstate banking region consisting of Delaware, Kentucky, Maryland, New Jersey, Ohio, Virginia, West Virginia, and the District of Columbia. Like New Jersey, Pennsylvania's law contains an anti-leapfrogging provision. The law also establishes a nationwide trigger date: March 4, 1990, when reciprocity will be extended nationwide. Pennsylvania's law also requires that certain criteria be met concerning the availability of banking services to individuals and businesses. The Pennsylvania Department of Banking must certify that Pennsylvania bank holding companies and out-of-state bank holding companies involved in interstate deals offer basic account transaction services and promote investment and employment in their communities.