

Public Policy Toward Interstate Bank Mergers: The Case for Concern

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I. INTRODUCTION

State by state, the legal prohibitions on interstate ownership of banking facilities are falling.¹ Congress has left it to the individual states to say when and how banks in each state may participate in interstate ownership arrangements.² Recognizing an overall national interest in the developing structure of banking, Congress has retained national authority to review and approve specific combinations.³ Despite this requirement, a pattern of combinations has emerged among the leading and major banks in the various states that allow interstate banking. This poses a major question for national banking policy: Should such combinations be generally permitted?

On its face, this pattern is troubling. A major stimulus to the development of our present banking system, with its diversity of services and efficient production techniques, has been vigorous competition. While bankers once believed that competition was contrary to the public interest,⁴ they now, in congressional testimony at least, claim economic competition is an important means to insure the public interest in an efficient, equitable, and progressive banking system.⁵ Moreover, economic theory, as well as historical and cross-sectional analyses of banking and financial services generally, all confirm the proposition that competition is an important positive force.⁶ Yet, interstate bank ownership does not increase competition directly, and affiliation among market leaders in different states will tend to link and entrench regional oligopoly.

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1. By early 1987, 40 states had authorized some form of interstate bank ownership. R. JONES & B. PULS, *INTERSTATE BANKING: A SUMMARY OF STATE LAWS* (1987). See also Simonson, *Full-Service Interstate Banking Statutes: The Conditions of Entry*, 11 OKLA. CITY U.L. REV. 723 (1986).

2. 12 U.S.C. § 1842(d) (1982).

3. 12 U.S.C. § 1842 (1982).

4. See *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 368-70 (1963).

5. *Hearings Before Subcomm. on Fin. Inst. Super., Reg. and Ins. of the House Comm. on Banking, Fin. and Urban Affairs*, 99th Cong., 1st Sess., 216-40 (Apr. 24 & 25, 1985) (statement of James G. Cairns, Jr.) [hereinafter *Bank Hearings*].

6. Economic theory recommends competition because it produces lower prices and greater output than other market structures. See, e.g., F. SCHERER, *INDUSTRIAL ORGANIZATION AND MARKET STRUCTURE* 12-14 (2d ed. 1980). Both historical and cross-sectional studies confirm the validity of this theory in that more competitive banking structures have yielded better performance. See, e.g., Berger & Hannan, *The Price-Concentration Relationship in Banking*, FED. RES. BD., FIN. AND ECON. DISCUSSION SERIES No. 23 (Apr. 1988); Clark, *The Efficient Structure Hypothesis: More Evidence from Banking*, 27 Q. REV. ECON. & BUS. 25 (1987); Evenoff & Fortier, *Geographic Deregulation of Banking: An Analysis of the Impact*, CONFERENCE ON BANK STRUCT. AND COMP. 701 (Fed. Res. Bank of Chicago, May 14-16, 1986) [hereinafter *BANK CONFERENCE*]; Gilbert, *Studies of Bank Market Structure and Competition: A Review and Evaluation*, 16 J. MONEY, CREDIT & BANKING 617 (1984); Stevens, *Bank Market Concentration and Costs: Is There X-Inefficiency in Banking?*, 18 BUS. ECON. 36 (1983).

Historically, the real but economically artificial limits on interstate ownership preserved a dispersed and unconcentrated national banking structure. Moreover, these limits had no serious efficiency costs. Over the years, the banking system has successfully solved the need for specific types of interstate integration by a great variety of cooperative efforts not involving interstate ownership of banks. These efforts apparently satisfied the economic needs for integrating the banking system and for providing services requiring greater geographic scope or greater resources than possessed by individual banks or banking organizations. Hence, there is no obvious efficiency justification for interstate bank ownership. Nonetheless, the banking community has vigorously insisted upon the right to combine on an interstate basis. State legislatures have generally approved. Judge Posner observed that when a regulated and protected industry obtains new rights which lack clear economic justification, it is at best problematic whether the result will be service to the public interest.⁷

This Article focuses on the merits of allowing interstate combinations of leading banks. In a nutshell, my thesis is that such combinations are extremely unlikely to produce otherwise unachievable, positive social benefits. Rather, these combinations are reasonably likely to produce a variety of undesirable social and economic effects. I should acknowledge at the outset that these negatives may not be substantively great. Nevertheless, given the lack of any generally positive effects, the net social cost-benefit balance is negative for such interstate combinations. This conclusion mandates a presumption against allowing combinations of leading banks. It also suggests that the present policy of the Federal Reserve Board (Board) of allowing large interstate banking combinations is at best ill-advised. Policy makers and enforcers ought to view such combinations very differently. Thus, I conclude that the present pattern of combinations in interstate banking presents a cause for concern.

I want to emphasize the limited nature of this critique. First, this is not a challenge to the idea of interstate bank ownership as such; instead, my analysis suggests that the public gains from any such combinations have been greatly exaggerated. The only concern addressed here is with a type of interstate bank combination that presently occurs.

Second, the focus of this analysis is strictly limited to the question of ownership. Bank regulation also entails many limits on what banks may do. Such conduct regulation is clearly distinguishable from ownership controls. The historical record as to conduct regulation suggests that such controls have had significant economic effects, many of which have been negative.⁸ The clear positive consequences of deregulation of conduct controls, *e.g.*, eliminating controls on interest on savings and

7. Posner, *Taxation by Regulation*, 2 BELL J. ECON. & MGM'T SCI. 22 (1971); *cf.* Benson, *The Economic Theory of Regulation as an Explanation of Policies Toward Bank Mergers and Holding Company Acquisitions*, 28 ANTITRUST BULL. 839 (1983).

8. See Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1 (1976); Hackley, *Our Baffling Banking System*, 52 VA. L. REV. 565 (1966); Loring & Brundy, *The Deregulation of Banks*, 42 WASH. & LEE L. REV. 347 (1985); Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1 (1977); Taggart, *Effects of Deposit Rate Ceilings*, 10 J. MONEY, CREDIT & BANKING 139 (1978); Wynne & Spagnole, *The Myth of Bank Deregulation*, 42 WASH. & LEE L. REV. 383 (1985).

demand deposits, has inspired suggestions for eliminating all controls over banking structure and conduct. However, the success of conduct deregulation has as an important predicate a structurally competitive market. Without competitive pressures, financial institutions are less likely to initiate desirable conduct or to maximize consumer welfare. Hence, the success of conduct deregulation provides no justification for elimination of structural controls and may depend, in the long run, on their continued viability.

Third, the case against certain interstate combinations expressly assumes that other methods of entry, including entry by newly organized banks, remains available.⁹ Manifestly, if existing competitors can make a market incontestable by obtaining a prohibition against important forms of entry, then the consequences for the public interest and consumer welfare will probably be negative. The central problem in such situations is to facilitate entry in ways that enhance competition. The focus of concern of this Article is the incremental positive or negative effect of permitting or restricting entry by one specific method: acquisition of a leading banking organization.¹⁰

This Article will first document that the pattern of bank combinations which is of concern does exist. Second, it will identify and evaluate the possible advantages to the public that may arise from such combinations. Third, it will catalogue and appraise the risks to the public interest and consumer welfare that may result from interstate combinations. Fourth, it will explain why, despite few real advantages and many potential risks, interstate combinations are likely to occur absent controls. Fifth, a simple cost-benefit analysis will demonstrate that the questionable gains from allowing large bank combinations do not justify the potential social costs. The implication of this conclusion is that such combinations ought to be forbidden. The final part discusses the possible legal and administrative means of controlling large bank combinations.

II. THE TROUBLESOME COMBINATIONS

Interstate banking came first on a regional basis to New England and the Southeast. It has now spread to the Midwest, Middle Atlantic, Southwest, and the Far West. While many states still limit the interstate ownership of banks to banking organizations serving adjacent or regional areas, there is a trend in various state statutes toward allowing nationwide ownership, provided that the other state offers

9. In fact, entry by acquisition of small and mid-sized bank organizations occurs as does entry by de novo chartering. See *infra* note 53 for examples. Some states forbid entry by new charter or acquisition of recently chartered banks. See, e.g., IDAHO CODE § 26-2607(d) (Supp. 1988) (bank must have been in business more than four years); WIS. STAT. ANN. § 221.58(4)(f) (West Supp. 1987) (bank must have been chartered five years or more). Such limits raise important questions about the legislative motivations in authorizing interstate banking, but it is also questionable how effective those limits would be. Cf. *United States v. Citizens & Southern Bancorp.*, 422 U.S. 86 (1975); *United States v. Marine Bancorp.*, 418 U.S. 602 (1974) (both cases discuss ways to evade analogous restrictions). For a critical commentary on such restrictive entry rules, see Ginsberg, *Interstate Banking*, 9 HOFSTRA L. REV. 1133 (1981).

10. I have consciously chosen not to define with any exactness what constitutes a "large" bank. As the following discussion will show, the source of concern is interstate combinations among banks ranked as being one of the top four or five largest in their home state (and sometimes additional states) combining with similarly ranked banks in still other states.

reciprocity as to ownership of banks within its borders.¹¹ Within each region, and now nationally, a similar pattern has emerged: large and leading banks in different states are combining.

In New England, the largest bank holding company in the region owns the largest banking organization in Massachusetts, the second largest banking organizations in Maine and Rhode Island, and the fourth largest banking organization in Connecticut.¹² The second largest New England banking organization has acquired what was, at the time, the largest bank in Connecticut, the second largest bank in Massachusetts, the fourth largest bank in Maine, as well as the fifth largest bank in Rhode Island.¹³ Another organization has recently combined two major New England holding companies resulting in the combined ownership of the largest banking organization in Connecticut, the third largest bank in Massachusetts, and the fourth largest bank in Rhode Island.¹⁴ In addition, the largest banking organization in Rhode Island controls the fifth largest bank in Maine and the tenth largest bank in New York.¹⁵

A similar pattern exists in the Southeast. The largest bank in North Carolina combined with the second largest bank in Georgia.¹⁶ Meanwhile, the second largest bank in North Carolina has combined with the third largest bank in South Carolina, acquired the fourth largest banking organization in Florida, and has recently acquired the largest banking organization in Texas.¹⁷ The third largest bank in Georgia joined forces with the second largest banking organization in Florida and has since acquired the largest banking organization in Tennessee.¹⁸ The largest banking organization in Georgia is also the fifth largest banking organization in Florida and the second largest banking organization in South Carolina.¹⁹ The third largest bank in North Carolina is also the sixth largest banking organization in Florida, the fourth largest bank in South Carolina, and the fourth largest bank in Georgia.²⁰ These organizations also are continuing to acquire additional banks.

The Middle Atlantic, Midwestern, and Western states seem poised for similar consolidations. The largest bank in Virginia has combined with the fourth largest banking organizations in Maryland and Tennessee.²¹ The fourth largest Virginia bank has acquired the sixth largest bank in Maryland.²² The largest Maryland bank has

11. See R. JONES & B. PULS, *supra* note 1; Simonson, *supra* note 1.

12. Bank of Boston, 70 Fed. Res. Bull. 737, 738 (1984).

13. Bank of New Eng. Corp., 72 Fed. Res. Bull. 138, 139 (1986).

14. Shawmut Nat'l Corp., 74 Fed. Res. Bull. 182, 183 (1988).

15. Fleet Fin. Group Inc., 74 Fed. Res. Bull. 62 (1988); Fleet Fin. Group Inc., 72 Fed. Res. Bull. 265 (1986).

In order to make its New York acquisition, Fleet must divest its Connecticut holdings that represent the sixth largest banking organization in that state. *Fleet*, 74 Fed. Res. Bull. at 63.

16. First Wachovia Corp., 72 Fed. Res. Bull. 61, 69 (1986).

17. NCNB, 72 Fed. Res. Bull. 57, 59 (1986); see also NCNB, 74 Fed. Res. Bull. 618 (1988) (order approving acquisition of First Republic Bank, the largest banking organization in Texas); Apar, *First Republic Bailout May Damage Capital-Raising Efforts by Other Banks*, Wall St. J., Aug. 1, 1988, at 3, col. 1.

18. SunTrust Banks, Inc., 73 Fed. Res. Bull. 67 (1987); SunTrust Banks, Inc., 71 Fed. Res. Bull. 176 (1985).

19. Citizens & Southern Bank, 72 Fed. Res. Bull. 260, 260 (1986).

20. First Union Corp., 72 Fed. Res. Bull. 798, 799 (1986); First Union Corp., 72 Fed. Res. Bull. 263, 269 (1986).

21. Sovran Fin. Corp., 73 Fed. Res. Bull. 939 (1987); Sovran Fin. Corp., 72 Fed. Res. Bull. 276, 277 (1986).

22. Bank of Va. Co., 72 Fed. Res. Bull. 65, 66 (1986).

acquired the second largest bank in the District of Columbia.²³ The second largest Pennsylvania banking organization has acquired the second largest Kentucky banking organization.²⁴ The third largest Pennsylvania banking organization has acquired the sixth largest banking organization in New Jersey, and the second largest banking organization in New Jersey has acquired the sixth largest Pennsylvania banking organization.²⁵ The fourth largest Pennsylvania bank has combined with the largest New Jersey banking organization.²⁶ In addition, the fifth largest Pennsylvania banking organization is combining with the third largest bank in Delaware.²⁷

In the Midwest, the second largest bank in Ohio has acquired the second largest bank in Indiana and the third largest banking organization in Wisconsin.²⁸ The largest banking organization in Ohio has acquired the largest bank in Kentucky.²⁹ The largest Michigan banking organization is also the fifth largest Illinois banking organization.³⁰ Many similar combinations are in the discussion stages.³¹

In the Far West, the First Interstate system, a relic of a period prior to control over interstate bank ownership, owns large banking organizations in Idaho, Utah, Nevada, Oregon, Arizona, California, Washington, and Colorado. It has recently acquired the fifth largest banking organization in Texas.³² The third largest California bank has acquired the second largest bank in Washington and the third largest banks in Arizona and Oregon.³³ The largest bank in California owns the largest bank in Washington.³⁴ In addition, the largest bank in Oregon now owns the third largest banking organization in Washington.³⁵

The pattern that emerges is clear and consistent. Leading bank organizations are combining.³⁶ The targets are sufficiently identifiable that a computer analysis can readily predict which ones they are.³⁷

The question the next two parts address is the identification of costs and benefits associated with this pattern of combination.

23. MNC Fin. Inc., 73 Fed. Res. Bull. 740 (1987).

24. PNC Fin. Corp., 73 Fed. Res. Bull. 227 (1987).

25. Midlantic Corp., 73 Fed. Res. Bull. 63 (1987); Core States Fin. Corp., 72 Fed. Res. Bull. 796 (1986).

26. FFB, Inc., 74 Fed. Res. Bull. 177 (1988).

27. Meridian Bancorp., Inc., 74 Fed. Res. Bull. 51 (1988).

28. Banc One Corp., 74 Fed. Res. Bull. 174, 176 (1988); Banc One Corp., 73 Fed. Res. Bull. 124 (1987).

29. National City Corp., 74 Fed. Res. Bull. 581, 582 (1988).

30. NBD Bancorp. Inc., 74 Fed. Res. Bull. 53, 54 (1988).

31. See Phillis & Pavel, *Interstate Banking Game Plans: Implications for the Midwest*, ECONOMIC PERSPECTIVES No. 23 (Fed Res. Bank of Chicago, Mar./Apr. 1986).

32. First Interstate Bank Corp., 73 Fed. Res. Bull. 881, 882 (1987).

33. Security Pacific Corp., 73 Fed. Res. Bull. 746 (1987); Security Pacific Corp., 73 Fed. Res. Bull. 381 (1987); Security Pacific Corp., 72 Fed. Res. Bull. 881, 882 (1986).

34. Bank of Am., 69 Fed. Res. Bull. 568, 570 (1983).

35. U.S. Bancorp., 73 Fed. Res. Bull. 941, 942 (1987).

36. As nationwide banking becomes lawful, more interregional combinations will also occur. See, e.g., Chemical N.Y. Corp., 73 Fed. Res. Bull. 378 (1987) (third largest bank in New York acquired fourth largest bank in Texas).

37. See Phillis & Pavel, *supra* note 31.

III. THE POTENTIAL GAINS FROM LARGE BANK MERGERS

This Part discusses the potential gains that large bank mergers can produce. The central question is: What are the expected public benefits of allowing interstate combinations of large banks? Three types of sources might provide initial answers to that query: legislative testimony, decisions authorizing such combinations, and scholarly writing. Each type has been examined and, surprisingly, few claims of benefits have emerged for examination.³⁸ This in itself is an observation of some significance. The primary policy arguments for interstate banking have nothing to do with the size of the banking organizations. Instead, the arguments are of the beneficial impact of freedom and the advantages of unprotected, competitively structured banking markets. The combinations here under review directly advance neither characteristic. Only by increasing the numbers of strong competitors serving specific markets can the general effect of increased competition be achieved; and the general value of freedom is fulfilled so long as banks can expand into any area in which they find it economically rational to provide service. Thus, the basic rhetoric justifying interstate banking is implicitly premised on the idea that the expansion be by new entry or foothold acquisitions rather than by combinations of dominant firms.

Identifying the claims made for large bank combinations is, however, only the first step. Each claim must then be examined critically to determine whether it qualifies as a valid benefit. Even if some private benefit might arise, to be a *public* benefit, it should satisfy an important condition: The benefit must be one that would not occur absent a merger or, if the benefit could occur absent a merger, it would arise only at significantly greater costs or be so delayed or incomplete as to make it substantially less worthwhile.³⁹ By definition, all other "benefits" of a combination could be achieved without the costs associated with interstate mergers and so can neither justify any such costs nor qualify as public benefits in this context.⁴⁰

A second important, but more empirical, question is the durability of the benefit. Transient benefits have less social utility than long term benefits. A short run gain resulting from a merger can logically offset a short run cost. When the cost is long run but the gain exists only for a limited time, a more critical appraisal is essential. Such an analysis requires selecting an appropriate perspective. Traditionally, economic analysis has focused on present values, which has the effect of discounting the future.⁴¹ A future-oriented concern would reverse that and discount present gains

38. In order to avoid setting up straw people and then demolishing them, I have not extended the list of possible benefits by adding my own nominees. However, my own review and reflection has not suggested any additional benefits which advocates of interstate banking have not identified which would be worthy of consideration.

39. This criterion rests on basic notions of allocative and productive efficiency, but also has explicit roots in bank merger control. *United States v. Third Nat'l Bank in Nashville*, 390 U.S. 171, 189 (1968); Carstensen, *Regulating Banking in the Public Interest: The Case for an Open Approach to Chartering and Branching*, 57 TEX. L. REV. 1085 (1979) [hereinafter Carstensen I].

40. As will be discussed, see *infra* notes 84-98 and accompanying text, it is possible to have a situation in which there are neither public benefits nor public costs. Such a situation would have to be resolved based on some *a priori* presumption.

41. For an extensive discussion of these issues, see Heller, *The Importance of Normative Decision-Making: The Limitations of Legal Economics as a Basis for a Liberal Jurisprudence—As Illustrated by the Regulation of Vacation*

which will not last into the future. For example, "improved management,"⁴² a frequent claim, is usually no more than the particular present abilities of those in charge of the surviving institution. Absent some assurance of continued, improved management, the significance of any such social benefit that arises as a result of merger seems marginal. The "publicness" of a benefit and its durability will be the two criteria by which the claimed benefits of large interstate bank combinations can be examined.

A. Congressional Hearings

The banking community has repeatedly sought national legislation authorizing interstate bank combinations. This legislation would pre-empt the various exclusionary schemes embedded in many existing state laws, and could open up states that have exercised their existing right to exclude interstate banking.⁴³ Despite the agitation, there have been few hearings actually devoted to building a record in support of interstate banking. The most substantial and clearly representative hearing was in 1985. That hearing revealed only three claims made on behalf of interstate bank ownership that could be attributed to all interstate combinations.⁴⁴

Then Federal Reserve Chairman Volcker, and spokesmen for major banks, claimed that interstate banking would stimulate actual and potential competition. Competition is very desirable for banking because it stimulates banks to provide new services and brings about a reduction in the prices charged for existing services.⁴⁵ Certainly the theoretical and empirical work on banking strongly supports this contention. Moreover, improved competition is a public benefit because it causes lower prices, improved quality, and more innovation. The relevant question is not, however, whether actual or potential competition is desirable, but how interstate banking and, specifically, interstate combinations of large banks can contribute positively to competition. Two possible connections might exist between interstate bank ownership and increasing actual or potential competition.

First, if banks in many states were too small in aggregate asset size to be efficient or were unable to offer a full range of the services needed by their customers, then interstate mergers, which increased substantially the size of the resulting banking organization, could convert it into an effective competitor, thus creating a public benefit. If this argument is correct, then we would expect evidence that banking involves substantial scale economies and that the size of a bank is closely related to the range of services that it can provide. This evidence would also suggest the scale

Home Development, 1976 WIS. L. REV. 385; for the traditional present value perspective, see W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE 261-81 (3d ed. 1988).

42. See, e.g., *Security Pacific Corp.*, 73 Fed. Res. Bull. 381, 383 (1987) (assuming for the moment that improved management is a benefit only achievable by merger). But see *Third Nat'l Bank*, 390 U.S. at 189.

43. See Miller, *Interstate Banking in the Court*, 1985 SUP. CT. REV. 179; Frieder, *The Interstate Banking Landscape: Legislative Policies and Rationale*, 6 CONTEMP. POL'Y ISSUES 41 (1988).

44. *Bank Hearings*, *supra* note 5. Although many other hearings have been held on banking issues, this is the only recent hearing to focus directly on these questions.

45. *Id.* at 5, 7 (statement of then Chairman Volcker); *id.* at 223 (statement of Am. Bankers Ass'n); *id.* at 491 (statement of John B. McCoy, Banc One Corp.).

required to achieve the necessary minimum aggregate size. This in turn would provide the basic criterion for determining whether particular combinations served the public interest.

Second, if banking markets were so oligopolistic or monopolistic that the existing banks were overcharging and underserving their customers, then the addition of new competitors in such markets would be likely to stimulate more service and lower prices. Interstate banking organizations might be better able to underwrite the costs of such new competition and might, because of their aggregate size, be better able to compete effectively from the outset.

The existing structure and well-known economic characteristics of the American banking system suggest that neither of these logical links between competition and interstate banking will provide a basis for finding benefits in interstate combinations of major banks.

Most studies of bank efficiency have reported that banks achieve scale economies at fifty to one hundred million dollars in deposits and that scope economies are not very substantial.⁴⁶ The consensus is that local banks can easily survive the onslaught of the large interstate banks.⁴⁷ Hence, each state already has substantial numbers of banks of efficient competitive size. Moreover, the aggregate size of a particular bank has only a limited bearing on its capacity to offer a wide range of services. Even a relatively small bank can provide specialized services through its correspondent relationships with other banks. In such situations, the local bank retails the services of a larger bank. Therefore, poor performance due to a lack of scale is wholly implausible as a justification for large interstate bank mergers.

The risks of anticompetitive oligopoly in local bank markets may be a better basis for encouraging interstate bank ownership.⁴⁸ Competition stimulates desirable conduct and performance. The question is whether there are serious existing problems with local market structures and how the combination of large banks would redress any such problems. Except with respect to one isolated, rural Ohio county, no evidence even suggested that there is a demonstrable problem of uncompetitiveness in banking markets today.⁴⁹ Moreover, if local market power were a major problem, the various federal banking agencies would not approve combinations that would

46. Bentson, Hanweck & Humphrey, *Scale Economies in Banking*, 14 J. MONEY, CREDIT & BANKING 435 (1982). See also D. FRASER & J. KOLARI, *THE FUTURE OF SMALL BANKS IN A DEREGULATED ENVIRONMENT* (1985); Berger, Hanweck & Humphrey, *Competitive Liability in Banking: Scale, Scope, and Product Mix Economies*, FED. RES. BD. RES. PAPER IN BANKING AND FIN. ECON. (Jan. 1986); Frieder, *The Southern Financial Market Place: The Florida Interstate Banking Study*, CONF. ON BANK STRUC. AND COMP. 23 (Fed. Res. Bank of Chicago, 1984); Goldberg & Hanweck, *What Can We Expect From Interstate Banking*, 12 J. BANKING & FIN. 51 (1988) (examination of comparative performance of interstate banks with more localized banks revealed no long run efficiency advantage for interstate banks); Nelson, *Optimal Banking Structure: Implications for Interstate Banking*, 6 CONTEMP. POL'Y ISS. 13 (1988). Cf. Brownstein, *The Big Are Getting Bigger as Banks Across the Nation Buy Other Banks*, NAT'L J., Oct., 1, 1983, at 2004 (quoting Federal Reserve Board staff and financial analysts to the effect that large banks are relatively inefficient and could improve profitability by getting smaller, not bigger).

47. See D. FRASER & J. KOLARI, *supra* note 46; Goldberg & Hanweck, *supra* note 46; Nelson, *supra* note 46.

48. Studies generally find a correlation between concentration and performance suggesting increased concentration results in less desirable performance. See *supra* note 6.

49. *Bank Hearings*, *supra* note 5, at 495 (statement of John B. McCoy). If anything, the bankers claimed that other financial services have more competitive ability and are more flexible than banks, making the financial services markets in which banks compete more, rather than less, competitive.

directly eliminate competition in such markets. Yet the agencies routinely approve almost every combination proposal. These approvals include findings that such combinations of direct competitors raise no serious competitive concerns.⁵⁰ This directly contradicts any claimed need for interstate expansion to increase competition.

The interminable debate over the effects of structure on performance also suggests that local banking markets are not seriously exploited even when highly concentrated.⁵¹ This is a consequence of the number of ways in which banking organizations can compete without ownership entry and the wide variety of nonbank financial institutions able to compete in local markets.⁵² This undermines the claim that ownership entry is essential to limiting the exploitation of local market power.

Second, the logic of a need to increase local market competition demands that entry come via *de novo* expansion or foothold type acquisitions.⁵³ The acquisition of leading banks in local markets by large out-of-area organizations would strengthen the leading banks and entrench the local oligopoly, reducing both actual and potential competition. Hence, the combinations being evaluated here would not contribute directly to increasing competition. Interstate combinations might contribute indirectly by making an existing dominant bank less effective as a local market force as a result of increased bureaucratization.⁵⁴ But, the crippling of a competitor, making it less effective and efficient relative to other institutions, is so perverse that it is unreasonable to regard it as a public benefit. A second indirect positive competitive effect would occur if the new bank could and would make entry into other concentrated markets that neither of its predecessors would have or could have done. Why the predecessors, which by hypothesis are already large banks, would not by themselves enter these other markets, but the resulting large bank would, is hard to explain in theory, and no example comes readily to mind.⁵⁵ In addition, no Federal Reserve Board decision has justified acquisition of a bank in a state on the basis of the need for improved competition in that state.

Perhaps the most important point about the claimed need to improve banking competition is that if it is a valid argument, it would argue against combinations

50. See, e.g., First Am. Corp., 74 Fed. Res. Bull. 567, 567-68 (1988) (merger approved between competing banks producing a 146 point increase in the HHI index in a highly concentrated market).

51. The question that has been repeatedly investigated is how much effect structure has on performance. See articles cited *supra* notes 6, 46.

52. For a discussion of the impacts of thrifts, see Watro, *Local Thrift Competition and Bank Earnings*, ECON. COMMENTARY (Fed. Res. Bank of Cleveland, Nov. 1, 1987).

53. Such entry does occur. See, e.g., NCNB Corp., 72 Fed. Res. Bull. 61 (1986) (entry into Atlanta by acquisition of a small bank); Fleet Fin. Group, Inc., 70 Fed. Res. Bull. 834 (1984) (entry into Boston and Hartford by *de novo* banks); Hartford Nat'l Corp., 70 Fed. Res. Bull. 353 (1984) (entry into Boston by purchase of an institution having a small share). In none of these cases did the Federal Reserve represent that the market being entered was so concentrated that entry was essential to stimulate competition.

54. Shull, *The Structural Impact of Multiple Office Banking in New York and Virginia*, 23 ANTITRUST BULL. 511 (1978) (study of market extension acquisitions showing acquired banks lost market share).

55. Manifestly, this is not a situation in which regulatory limits are a problem. This is purely a problem of which institutions can and will enter a particular area. It bears emphasis here that one must consider all potential entry vehicles and claims that interstate banks make a noticeable contribution to the pool of such potential entrants. Cf. Frieder, et al., *Legislating for Interstate Bank Expansion: Financial Deregulation and Public Policy*, 9 J. CORP. LAW 673, 749 (1984).

between large banks in different states. Such combinations are unnecessary for efficiency and are the least likely to improve competition in either market.⁵⁶

Whatever the merits of the claim that interstate banking will improve competition in general, the claim provides little basis for combinations involving large banks. If anything, the claim that it is important to increase competition would suggest that such mergers are undesirable. The only exception would be a very unusual, but easily identifiable case, in which the resulting bank would be a meaningful potential competitor in markets in which its constituent banks could not compete, absent a merger. In addition, for the gain to be at all meaningful, the market(s) thus opened would have to have high existing concentration.⁵⁷ Finally, to get the potential social benefit, it would be necessary to require that the new bank enter the target market *de novo* or by a foothold acquisition. This once again shows that combinations between large and locally dominant banks are a potential source of competitive concern.

A second argument advanced to Congress by proponents of interstate bank mergers is that the new interstate combinations would provide increased consumer services. Somehow the interstate bank, representing a multibillion dollar combination, will do things for consumers that its constituent banks, each with several billion dollars in assets, had not done and could not do before. Specific examples of new or improved services were rare. One banker did claim that many people cross state lines and attempt to cash checks, but they cannot because their bank does not have offices in the adjacent state.⁵⁸ Should one be more concerned about the manifest ignorance of a banker who makes such a statement or the legislator who fails to challenge it?

In fact, bank customers already have many services, including bank credit cards and check guarantee programs, which allow them to cash checks or obtain cash transfers throughout the United States and much of the world. Moreover, most predictions about interstate bank combinations suggest that in significant areas of the country, only nonownership systems will make it possible to get access to bank services.

Generally, existing large banks already compete in consumer services outside their home states through nonbank subsidiaries, correspondent arrangements, and direct interstate services such as credit card programs. Given all the means by which banks compete to provide consumer services, it is hard to see why ownership of a bank in another state, let alone a large bank, has any logical relation to the scope or

56. One empirical study reported that intermarket combinations among leading banks tended to cause the acquired bank to lose market share. Shull, *supra* note 54. See also Apcar & Brown, *Small Texas Towns Are the Latest Victims of Business Banks' Crisis*, Wall St. J., May 25, 1988, at 1, col. 6; Helyar, *Multistate Banks Rile Many Customers*, Wall St. J., Apr. 20, 1988, at 21, col. 3. Given the likely efficiency costs of such combinations, such results are understandable. See Nelson, *supra* note 46. The idea that intermarket combinations among leading banks should be favored because of their crippling effects on the participants seems very dubious from the standpoint of broader policy concern with the safety, soundness, and viability of banks.

57. The merger of several banks which as a result can now enter New York City, Chicago, or Los Angeles does not significantly add to the competitiveness of these markets and so lacks any substantial positive feature to offset any negative effects.

58. *Bank Hearings*, *supra* note 5, at 163, 506 (statements of John W. Woods, Ass'n of Bank Holding Companies and of John Petty, Marine Midland Bank). Cf. Marine Bank, *Our Name Change Raises Some Good Questions*, Spring 1988 (brochure of Wisconsin bank being acquired by an Ohio bank to its customers justifying the merger by promising check cashing "at any . . . office . . . in the Midwest with proper identification") (emphasis added).

quality of services offered. Recent anecdotal evidence suggests that, in many regions, interstate bank ownership has caused a deterioration of the quality of consumer services.⁵⁹ Interstate banks may be more adept at exploiting consumers by charging higher prices for services, but it is at least questionable if they improve services.⁶⁰ In sum, consumer advantages from interstate bank combinations are not evident or substantial, and no consumer advantages seem to turn on the combination of ownership of large banks.

The third argument for interstate bank mergers advanced at congressional hearings was that the resulting banks would be more able to provide large loans to commercial and industrial borrowers.⁶¹ Once again this claim requires careful inquiry as to the need for large traditional loans and, assuming a need, the ways in which this need might be fulfilled.

The first question that must be answered is whether or not the addition of more banks, which are able to make large loans on their own, is a desirable goal. If the change from a loan limit of ten million dollars per customer to one of thirty or forty million dollars were important, there should be evidence that borrowers needing loans in the thirty to forty million dollar range are unable to find them in the market at competitive rates. In fact, recurring reports of low earnings from corporate lending programs by the largest banks, and their other well-documented problems with large loans, suggest that borrowers already have a competitive loan market.⁶² Nor is there evidence that the large banks that have merged have made any appreciable number of loans at or near their lending limits or that these banks had worthy customers whose needs were not accommodated prior to the merger. Consequently, there is no evidence of a need for significantly increased loan limits of the sort produced by the combination of large interstate banks.

Equally important, interstate combinations will rarely increase the quantity of large loan lending actually available to customers. In other words, the availability of large loans is independent of the specific size of the bank that arranges the loan. A smaller bank originating large loans beyond its own lending limit generally cooperates with other banks to cover that portion of the loan that is beyond its own lending limits. This participation in lending has a number of virtues. It is a good risk distributor, and an efficient way to diversify portfolios. In the long run, multibank cooperation in lending is likely to be more efficient than single firm efforts because each participant has incentives to innovate and to develop alternatives. The greater

59. See Helyar, *supra* note 56.

60. See, e.g., Mitchell, *Banc One Breaks Mold and Gets Ahead*, Wall St. J., June 13, 1988, at 17, col. 1; Spivak, *Banc One Changes Indiana Game*, Milwaukee Sentinel, Apr. 1, 1988, sec. 2, at 5, col. 3 (both stories suggest Banc One has succeeded in raising consumer prices in banks it has acquired). See also Bailey, *Major Credit Card Issuers Tighten Grip on Market Despite High Interest Charges*, Wall St. J., July 29, 1988, at 17, col. 4.

61. *Bank Hearings*, *supra* note 5. Overall, without interstate ownership, bank sizes have kept pace with the growth of their customers. Rhodes, *Are the Big Banks Big Enough?*, 26 ANTITRUST BULL. 315 (1981).

62. Baer, *Regulatory Burden Handicaps Low-Risk Banking*, CHICAGO FED. LETTER No. 5 (Jan. 1988) (from 1975 to 1985, bank lending to large manufacturers has declined dramatically). Mitchell, *Mellon Faces Obstacles in Restructuring*, Wall St. J., Aug. 9, 1988, at 26, col. 3; see also Gregorash & Ford, *Banking 1987: A Year of Reckoning*, 12 ECON. PERSPECT. No. 4, at 1, 5-6 (1988) (in both 1986 and 1987 the largest banks, those over \$10 billion in assets, had average returns substantially below smaller banks).

flexibility of this ad hoc cooperative system means that participants can compete both within the project to provide key services as well as outside the project to innovate new solutions. This provides more intense competitive pressure on the lending system insuring both productive and dynamic efficiency. Indeed, one of the most important innovations in the banking business over the last 100 years has been the development of cooperative systems for making large loans.⁶³ Hence, increased lending limits for individual banks do not respond to any clear social need. Even assuming a need, combination among large banks is not the best way to accumulate the funds needed for very large loans. Therefore, no public benefit results from the increased lending limits.

Banks provide other services to their major customers. However, no one has claimed that interstate merger is essential for providing these services. Manifestly, the correspondent banking system is such that it would be almost impossible to find an important and profitable service that could not be efficiently delivered anywhere in the country where customers might want it.

For more than 100 years, American banks have used various types of cooperative efforts to provide for interstate delivery of services and to provide funds for any loan request which is beyond the limit of any particular bank. As a result, it is not surprising that the proponents of interstate bank mergers could not produce a significant record of activities or services that would be enhanced by interstate ownership combinations.

In sum, despite the ardent advocacy of interstate banking by a wide range of witnesses, the legislative hearings failed to provide credible support for interstate consolidations of major banks.

B. *The Federal Reserve Opinions*

The Board opinions approving interstate combinations provide a second and potentially better source of possible justifications for such mergers. In order to be approved, any interstate combination must satisfy the "convenience and needs" criterion.⁶⁴ This requires the Board to find that the merger will make a positive contribution to the public interest.⁶⁵

Unfortunately, in cases involving combinations of banks having leading positions in two states, the Board's standard statement is: "Considerations relating to the convenience and needs of the communities to be served are also consistent with approval."⁶⁶ This is hardly illuminating except in the negative. Manifestly, the Board's opinion writers could find nothing specific nor positive to say about the

63. See Keehn, *Market Power and Bank Lending: Some Evidence from Wisconsin, 1870-1900*, 40 J. Econ. Hist. 45 (1980).

64. 12 U.S.C. § 1842(c)(2) (1982).

65. See Carstensen I, *supra* note 39, at 1113-25; see also Carstensen, *Restricting the Power to Promote Competition in Banking: A Foolish Consistency Among the Circuits*, 1983 DUKE L.J. 580 [hereinafter Carstensen II].

66. E.g., First Wachovia Corp., 72 Fed. Res. Bull. 68, 70 (1986); accord Banc One Corp., 74 Fed. Res. Bull. 174, 176 (1988); Fleet Fin. Group, 74 Fed. Res. Bull. 62, 65 (1988); Sovran Fin. Corp., 72 Fed. Res. Bull. 276, 278 (1986); Bank of Boston, 70 Fed. Res. Bull. 737, 739 (1984); Bank of Boston, 70 Fed. Res. Bull., 524, 525 (1984).

public benefits from interstate combinations. In its *SunTrust* opinion, the Board declared that:

Applicant *has stated* that the proposed combination . . . will permit each to offer *improved and expanded services* to customers and to the communities they serve. Accordingly, the Board has determined that considerations relating to the convenience and needs . . . are consistent with approval.⁶⁷

Because that is the full text, we do not know what services were needed that a 7.3 billion dollar banking organization and a 3.7 billion dollar banking organization could not individually provide, but could only be provided if they combined to create an 11 billion dollar institution.

In a number of recent decisions, the Board has discussed challenges to the merger based on the requirements of the Community Reinvestment Act (CRA)⁶⁸ within its convenience and needs discussion.⁶⁹ Because bank agencies must deny requests for mergers of banks failing to comply with the bank's duty under the CRA, local groups have challenged combinations in an effort to force the applicant and, rarely, the acquired bank, to perform better. The Board apparently uses its review procedures to require acquiring banks to improve their conduct at their existing facilities.⁷⁰ The Board uses a positive finding on the CRA issue as a basis for a positive convenience and needs conclusion. Requiring a bank to live up to its statutory duty is in some sense a positive result, but it has nothing to do with the acquisition of a leading bank in another state except as a bribe.

To put it bluntly, the Board's decisions authorizing interstate combinations provide no basis for the belief that any specific public benefit will result from these combinations. Moreover, there is some empirical evidence to give reason to doubt that even the claimed benefits will be provided.⁷¹

In a few cases, usually involving the acquisition of a less substantial bank, the Board has made more specific findings which show just how minimal the real advantages are of even smaller interstate combinations. Thus, in approving Hartford National's acquisition of Arltru Bancorporation in Boston, Massachusetts, the Board declared that the combination "would permit Arltru to provide additional credit capacity to serve more and larger commercial customers . . . [and to] expand . . . [its] trust department as well as its mortgage lending, municipal financing, and commercial banking services."⁷² But, a page earlier, the Board reported that Hartford already had a loan production office in Boston. Hence, Hartford's "additional credit

67. *SunTrust Banks, Inc.*, 71 Fed. Res. Bull. 176, 179 (1985) (emphasis added).

68. 12 U.S.C. §§ 2901-2905 (1982).

69. See, e.g., *National City Corp.*, 74 Fed. Res. Bull. 581, 583-85 (1988); *Shawmut Nat'l Corp.*, 74 Fed. Res. Bull. 152, 185 (1988); *Valley Nat'l Corp.*, 74 Fed. Res. Bull. 57, 58-59 (1988); *Sovran Fin. Corp.*, 73 Fed. Res. Bull. 939, 941 (1987); *First Interstate Bankcorp.*, 73 Fed. Res. Bull. 881, 883 (1987).

70. See, e.g., *Sovran Fin. Corp.*, 73 Fed. Res. Bull. 939 (1987); state regulators seem to use the same tactic. See *Comerica Purchase is Tied to Proposal For Detroit Lending*, *Wall St. J.*, Aug. 2, 1988, at 4, col. 2 (Michigan banking commissioner conditioned grant of right to buy a Texas bank organization on Michigan acquirer improving its conduct in Michigan).

71. Allardice, *Convenience and Needs Considerations: A Post-Audit Survey*, STAFF MEMORANDA NO. 78-2 (Fed. Res. Bank of Chicago) (undated).

72. *Hartford Nat'l Corp.*, 70 Fed. Res. Bull. 353, 355 (1984).

capacity” as well as its capacity to provide any other lending services were already present in the market. Hartford’s combination with Arltru did not increase the sum of services available to Boston area banking customers; it only altered and combined a source of service. At most, this merger expanded a trust department in one Boston area bank at the cost of eliminating existing competition in a variety of other lending services. Moreover, there is no finding that an expansion of trust services would improve either the competitive character of the market or lower significantly the costs of providing trust services.⁷³ The Board declared that Boston area banking has a highly competitive structure and made no separate findings about the trust business.⁷⁴ Hence, it is not clear that any positive effect will result from this combination, and it is quite obvious that the findings with respect to the claimed positives do not satisfy the conditions necessary to classify them as public benefits.

Similarly, in approving the acquisition of a 200 million dollar bank in Salt Lake City, the Board found that the convenience and needs of the community would be served because the combined entity would “enable [the] Bank to expand the scope and array of its services.”⁷⁵ However, the acquirer, through two nonbank subsidiaries, already provided all or most of these services in Salt Lake City.⁷⁶ Consequently, consumers of financial services in Salt Lake City did not receive any net increase in the services being offered and lost a possible source of competing offers of service. Once again, the public benefit criteria are not satisfied, even if one assumes that the merger is a positive outcome for the bank in question.⁷⁷

In only one recent decision involving an interstate combination of large banks has the Board even addressed a list of plausible positive factors. The Board listed three positive features: injection of capital, increased managerial expertise, and consolidated operations which would produce “anticipated benefits” in the form of lower costs.⁷⁸ Recognizing the doubtfulness of the third claim,⁷⁹ and the transience of the second,⁸⁰ the Board emphasized the injection of capital that would occur.⁸¹ Assuming that the target bank was not seriously embarrassed financially, this too is a weak claim because options other than merger exist to provide capital. In short, the expected positive gains from this combination seem minimal, unlikely, or of doubtful duration.

73. To find a public benefit in this aspect of the transaction we must assume that scale is important in trust services but effective competition requires a local presence. Nothing in the Board’s opinion supports either assumption.

74. Hartford Nat’l Corp., 70 Fed. Res. Bull. 353, 354 (1984). *See also* Key Banks, Inc., 71 Fed. Res. Bull. 587, 588 (1985) (the convenience and need justification for the takeover of a bank in Fairbanks, Alaska, came from an increase in the number of banks in that market offering “automobile leasing, discount brokerage services, electronic banking services, and credit life and accident and health insurance.” Yet in no instance did the Board find that there was a need for increased competition in any of these lines.).

75. Moore Fin. Group Inc., 71 Fed. Res. Bull. 899, 900 (1985).

76. *Id.*

77. Indeed, in these opinions the Board has attempted to convert the public convenience and needs criterion into a bank convenience and needs standard. This lacks statutory as well as policy justification.

78. Security Pacific Corp., 73 Fed. Res. Bull. 381, 383 (1987).

79. *See* Nelson, *supra* note 46; *see also* Staff, Davidson & McDonald, *Increased Bank Merger Activity: Causes and Effects*, 24 Am. Bus. L.J. 67 (1984).

80. *See supra* note 42 and accompanying text.

81. Security Pacific Corp., 73 Fed. Res. Bull. 381, 383 (1987).

There is one final group of cases in which the Board has stronger evidence of actual positive public benefits. These cases involve the acquisition of institutions with serious capital deficiencies. When the acquirer is an out-of-state institution, the combination produces an infusion of capital with a minimal elimination of existing competition.⁸² In most cases of this type, direct investment in the weak bank is not practical and its failure would produce a higher cost to the insurance fund and to those whose banking relationships would be disrupted. Hence, allowing interstate combinations in such situations provides positive results and confers public benefits. These acquisitions provide an example of a valid public interest justification for interstate combinations among large banks. What is striking is that this is the only instance of a clear public benefit which emerges from a review of the many decisions authorizing interstate combinations, and it justifies only a limited number of the actual combinations.

In sum, the Federal Reserve opinions, like the legislative hearings, demonstrate that there is no significant public advantage resulting from interstate combinations. The minor advantages that were found were frequently already being provided through means other than merger. Moreover, if there are any unfulfilled banking service needs in these markets, it is evident that there are many means, other than merger between leading banks, that will provide the needed service.⁸³ The sole exception to this conclusion is the acquisition of a failing bank.

C. *The Academic Literature*

A critical review of the academic literature in the areas of finance and law similarly justifies the conclusion that interstate combinations between large banks will rarely produce public benefits. The legal literature on interstate banking is largely devoted to the legislative and constitutional issues with respect to regional banking systems.⁸⁴ Other articles discuss the competitive impact (or lack of impact) of

82. See, e.g., First Interstate Bancorp., 73 Fed. Res. Bull. 881 (1987); Chemical N.Y. Corp., 73 Fed. Res. Bull. 378 (1987); Bank of New Eng. Corp., 72 Fed. Res. Bull. 138 (1986); The Chase Manhattan Corp., 71 Fed. Res. Bull. 960 (1985); The Chase Manhattan Corp., 71 Fed. Res. Bull. 633 (1985); FNB Corp., 71 Fed. Res. Bull. 340 (1985).

83. One other claimed advantage that purportedly depends on a massive increase in the consolidation of banks across the country revolves around the inefficiency of the present system of check collection. Berger & Humphrey, *The Role of Interstate Banking in the Diffusion of Electronic Payments Technology* (Fed. Res. Bd. Working Paper, July 1985). Despite the greater efficiency of other systems, the float advantage remains with the check writer. For competitive reasons banks refuse to charge their customers the full costs of the inefficient system. This in turn keeps the more efficient systems from being attractive. The authors theorize that if large numbers of interstate bank mergers occur, the resulting massive banks will confront the float problem as an internal cost along with the internal cost of clearing checks inefficiently. They will then respond by forcing their customers to use more efficient systems for clearing transactions and impose the costs on the customer. The flaws in this claim are several. First, the source of the problem resides in the Uniform Commercial Code which makes an economically undesirable allocation of rights. Change those rights, and the problem will be self-correcting. Second, banks have already identified the customers who can most reduce bank costs by switching to other payments systems. By suitably rewarding more efficient conduct, banks have caused major changes in behavior. Manifestly, banks can also pay their ordinary customers to forego the float and use another system. Finally, there is some reason to doubt that the same efficiencies will occur when such systems deal with large numbers of individual transactions. There may also be some substantial costs which the study did not include which customers will have to bear.

84. See Miller, *supra* note 43; Miller, *Interstate Branching and the Constitution*, 41 Bus. Law. 337 (1986); Frieder, *supra* note 55.

interstate mergers on small banks.⁸⁵ Other articles report on various state laws.⁸⁶ With few exceptions, there are no sustained investigations into the policy questions of whether interstate banking is generally a good idea and what are the merits of limiting interstate combinations when both banks are large.⁸⁷ One survey article did present arguments on both sides, but did not critically examine those claims.⁸⁸

The positive argument in many of these articles is in reality a reverse negative: there is no strong evidence of serious bad effects. Therefore, all combinations should be allowed unless they would create provable negative effects.⁸⁹ The positive claims are similar to those which have already been examined: better management, increased efficiency, increased service, and deconcentration. These claims are no better supported in the scholarly writing than in the congressional hearings or Board decisions.⁹⁰

One claim worthy of more attention than it has received is that interstate mergers allow large banks to acquire more stable deposit bases.⁹¹ Such money center banks today often "buy" deposits from smaller banks to support their lending. These purchases often take the form of buying deposit claims for the overnight period during which a bank must satisfy regulatory requirements as to loan to deposit ratios. Such purchased deposits, as well as funds attracted by other kinds of price competitive deposit solicitation, are quite price sensitive. Relying on such deposits requires that a bank be an efficient and profitable lender. By acquiring ownership of substantial banks with stable consumer deposits, the large banks can avoid some of the price competition they would otherwise face. While this may be desirable from the perspective of the specific bank, it is not in the long run interest of depositors or efficient banking generally. Purchasing such nonprice competitive funds is a way to avoid competition by acquiring a right to funds held at below market rates. The large banks have simply captured a lower cost source and not improved the overall efficiency of the banking system. In fact, they are merely exploiting the informational and institutional failings of the present system. In any event, if changing the source of deposits for large banks is socially desirable, the large banks can achieve this by

85. See, e.g., Rose & Savage, *Interstate Banking and Viability of Small Independent Banks: Further Evidence on Market Share Accumulation by New Banks*, 32 ANTITRUST BULL. 1007 (1987).

86. See, e.g., Given, *Midwest Regional Interstate Banking*, 17 LOY. U. CHI. L.J. 533 (1986).

87. The major exception is then Professor (now Judge) Ginsberg's lengthy article in which he argued for interstate banking. Conspicuously, given Judge Ginsberg's Chicago credentials, he urged that combinations of large banks be disfavored. Ginsberg, *Interstate Banking*, 9 HOFSTRA L. REV. 1133 (1981).

88. Frieder, *supra* note 55; see also Cohen, *Interstate Banking: Myth or Reality*, 18 LOY. L.A.L. REV. 965 (1985).

89. See, e.g., Miller, *Public Policy Implications of Legislation Limiting Growth of Interstate Banks*, BANK CONFERENCE, *supra* note 6, at 602; Cohen, *supra* note 88 (Cohen specifically claims antitrust law will preclude too much concentration).

90. Cohen, *supra* note 88; Freeman, *Interstate Banking Restrictions Under the McFadden Act*, 72 VA. L. REV. 1119 (1986). Both suggest that a multistate bank can have greater loan diversity. This reflects a serious ignorance of both present and historic use of loan participations and loan sales as means of diversifying portfolios of banks. See Keehn, *supra* note 63; see also Keehn, *Federal Bank Policy, Bank Market Structure and Bank Performance: Wisconsin 1863-1914*, 48 BUS. HIST. REV. 1 (1974).

91. It is hard to find any author who expressly justifies mergers on this ground, perhaps because of its dubious consumer welfare justification. Yet, empirical analysis of interstate combinations of large banks often point out that strong consumer deposit bases, as well as relatively low commercial and industrial loan to asset ratios, are frequently features of acquired banks. See Buynak & McElravey, *infra* note 155; Buynak, *infra* note 128; see also Phillis & Pavel, *supra* note 31.

entering new markets and competing for such deposits rather than simply buying up existing deposit bases. Such competition would tend to raise the price paid for such funds to the market level.

The finance and economics literature is equally devoid of policy discussions focused on the merits of interstate bank combinations.⁹² This literature does contribute greatly, as the next subpart will illustrate, to the belief that interstate combinations create risks of negative economic effects. Yet no one has drawn the strands together to see what they suggest about the public policy implications.

There is also a body of descriptive, predictive writing about interstate banking. While this literature does not contribute direct insight into the public benefits of interstate combinations, it does tell what the private benefits are. The fact that the public and private benefits diverge and that private gains may exist even when no public gains exist are helpful in explaining why such combinations will occur despite their lack of public benefit.

D. *An Explanation for the Lack of Public Benefits*

This review of the claims for improved efficiency or other socially desirable consequences resulting from large bank combinations shows that the common assumption that increased size, especially as a result of merger, will improve economic efficiency is false—at least in the case of banking. The discontinuity between a popular as well as scholarly presumption of efficiency and the empirical reality is very significant. If there are in fact few, if any, likely efficiency gains that will result from such combinations, and if we assume bank managers are rational economic actors, then there must be other nonefficiency explanations for large bank combinations. Analysts of public policy toward business combinations must abandon presumptions and look critically at the empirical data. When they do, they will recognize that a promoter public policy toward banking can find no real justification in the claim of economic efficiency.

The presumption of efficiency rests on the unexamined premise that large size, especially achieved by merger, is qualitatively different from other ways in which large groups of assets can be marshalled to respond to an economic need. This assumption is untenable as a matter of theory. Markets, contracts of various kinds, as well as ownership, are all substitutable means to organize and coordinate economic activity. There is no theoretical reason to predict that one method will be more efficient than another in the abstract. The particulars of the institutional and technological realities will dictate the answer.

The lack of significant public benefits from a new type of merger is not surprising given reasonable substitutability among the various methods of coordinating economic activity. The only effect that bank ownership law ever had was to restrict interstate ownership of banking facilities. The law never forbade the development of interstate banking through joint ventures, cooperation, event specific contracts, and

92. *But see* Nelson, *supra* note 46.

other nonownership means. To the extent that, as in credit cards, interstate cooperation was useful, it has occurred. To the extent that, as in making very large loans, a greater pool of assets was needed than the individual banks had, pooling on an ad hoc basis has occurred. When specialized services required a greater volume of business than an individual bank could produce, and customers demanded these services, either a joint venture supplied the services or correspondent banks provided them.

Since the last century, the United States has had an interstate banking system.⁹³ Until recently, the ownership of participating units was confined within state boundaries or smaller areas. But that limit on ownership has not proven to be a significant barrier to efficiency.⁹⁴ In fact, overall, the American system of dispersed ownership has proven to be an efficient, progressive, and effective banking system. Interstate ownership offers only a different form of integration across state lines. Unless interstate ownership provides a more efficient alternative to the existing means of integration, one should not expect that interstate ownership will provide any advantages over the existing system of interstate bank organization.⁹⁵

Contracts and markets can be substitutes for interstate ownership, as the history of American bank integration teaches. Yet, there is an unarticulated assumption that ownership is always the most efficiently productive form of interstate integration. Indeed, actual economic experience suggests that in the long term, there is little difference between the present interstate integration system and interstate ownership. Frequently, the less integrated form of economic coordination proves more efficient over time. It would unduly expand this essay to develop the latter statement in any rigorous way.⁹⁶ Suffice it to say here, because of the artificial limits on the geographic scope of bank ownership, the legal regulatory and banking systems were under sustained pressure to define, promote, and legally facilitate nonownership solutions to problems of integration. Again, the experience of banking is strong historical evidence that nonownership integration, properly nurtured, can achieve efficiency comparable to, or better than, that of ownership integration.

If it is true that ownership is simply a formal, and not the only functional, means of economic integration, it follows that a change in bank ownership rules will not increase noticeably the overall efficiency and social utility of our banking system. Consequently, the public interest argument for interstate bank ownership is remarkably weak.⁹⁷ Two policy concerns exist which might still create a positive justification for interstate banking: an ideological commitment to limit regulation, and the general social value of freedom of action.⁹⁸ But these values only justify

93. See Keehn, *supra* note 63; Keehn, *supra* note 89.

94. Cf. Nelson, *supra* note 46.

95. Cf. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1938).

96. The core of the hypothesis is that methods of legal control are formal and not functional. Therefore, given time and need (demand), the practical problems of efficient interrelationships can be resolved using any method of formal control.

97. Cf. Nelson, *supra* note 46.

98. I have elaborated elsewhere on the role and relevance of such "tie-breakers" in determining public policy. See Carstensen I, *supra* note 39, at 1104-05.

allowing interstate banking as a general right to expand across state lines by opening offices; neither value would require combining viable major banks in different states.

IV. THE SOCIAL COSTS OF LARGE BANK MERGERS

Proving that interstate combinations of large banks make no positive contribution to the public good in general does not prove that they have any negative effects. It is possible, after all, that reorganization of ownership has no significance. If, in fact, no serious negative risks existed, then the argument for allowing large bank combinations would prevail as long as there is a preference for allowing freedom of action for businesses.⁹⁹

The combination of large banks can, however, result in a number of negative effects. This Part will list and discuss them. The risks are not limited to traditional competitive concerns. In fact, perhaps the greatest risks are of possible increased regulatory and efficiency costs. Moreover, there are a variety of nontraditional competitive and market risks that interstate combinations also create.

A. Efficiency and Regulatory Risk Avoidance

Almost all the data on bank efficiency points to the conclusion that there are not only no scale economies, but diseconomies will occur as banking organizations grow.¹⁰⁰ The probability of diseconomies also increases as banks become spread over wider geographic areas. The costs of monitoring and supervising expand as layers of supervising authority must be created.¹⁰¹ The result is that large-scale interstate branch systems are costly to operate.¹⁰² The inefficiency of large banks indicates that these banks will be less profitable and will use more of society's resources to achieve the same output. Neither consequence serves consumer welfare or any other public interest.¹⁰³

A likely consequence of the development of a system of inefficient banks is that inefficient banks will pressure regulators for protection from more efficient competition. One can easily visualize renewed regulation to protect these giant dinosaur banks from efficient competition for consumer loans, deposits, and business loans. Therefore, in order to protect the established order, there will have to be further dampening of efficient competition with resulting costs to consumer welfare.

Another potential outcome of the creation of large inefficient banks, particularly in the context of deposit insurance and other protections, is that managers will

99. Cf. W. HURST, *CONDITIONS OF FREEDOM* (1956); Miller, *supra* note 88.

100. See studies cited *supra* notes 6, 46.

101. One might claim that the increased monitoring costs are the internalization of costs which would otherwise have appeared as expenses of bank regulation. Several considerations require the rejection of such a claim. First, internal monitoring does not and cannot replace external supervision given deposit insurance and a general public concern with bank safety and soundness. Second, as discussed below, the more dispersed a bank, the more difficult is any necessary regulatory monitoring. Finally, bank examiners are both less costly than high priced vice presidents and have, because of the nature of their relationship to the bank, better incentives to identify problems.

102. See *First Interstate Says Big Layoffs Possible In Bid to Cut Costs*, *Wall St. J.*, July 3, 1988, at 15, col. 3. Cf. Brownstein, *supra* note 46; Shull, *supra* note 54; Stevens, *supra* note 6.

103. See R. POSNER, *ECONOMIC ANALYSIS OF LAW* (2d ed. 1977). Cf. R. BORK, *ANTITRUST PARADOX* (1978).

take high risks in the hope of receiving positive returns. Managers will have a tendency to seek out and promote higher risk, larger loans.¹⁰⁴ At best, this will add to the regulatory costs because it will require increased external monitoring of increasingly complex organizations. At worst, it will create a recurring pattern of losses and crises in the banking system.

In ordinary business situations, inefficient firms would either fail or be taken over by new managers, who would break them into smaller, more viable enterprises. Neither of these checks exist in the banking system with respect to large banks.

Because of the perceived costs to the banking system as a whole from the failure of the largest banks, bank regulators have declared that very large banks are invulnerable to failure.¹⁰⁵ This protectionism has several consequences. It loosens even further the market discipline that would otherwise force a bank to operate in rational, efficient, and desirable ways.¹⁰⁶ Second, it creates an additional reason for regulators to discourage effective competition which might threaten a tottering enterprise. Third, it confers on shareholders of the largest banks an unearned increase in share value.¹⁰⁷ This last consideration also creates a strong nonefficiency-based reason for banks, not already in the protected category, to expand their size by major acquisitions. Then they will also be protected and can reap the unearned increment in share value. Finally, it is very costly to the public treasury.¹⁰⁸

As a bank gets larger, it also becomes less vulnerable to takeover.¹⁰⁹ Many believe that the risk of takeover serves as an important control over inefficient management.¹¹⁰ To the extent that the risk of takeover induces less shirking and discourages opportunistic behavior by managers, creation of very large banks can eliminate or reduce this beneficial control. In takeovers in banking, the buyers are substantially larger than their targets.¹¹¹ Barring combinations of major interstate banks may not make them more vulnerable to hostile takeovers; but as smaller banks, they are more easily pursued by other takeover techniques. Moreover, if a bar on major combinations stimulates other forms of entry, the resulting increase in direct

104. This is at least part of the story behind the problems of the large Texas banks and the disaster of Continental Illinois. See O'Driscoll, *Bank Failures: The Deposit Insurance Connection*, 6 CONTEMP. POL'Y ISS. 1 (1988). Cf. Hilder, *Thrift-Industry Crisis May Force an Overhaul of Deposit Insurance*, Wall St. J., July 27, 1988, at 1, col. 6.

105. *Inquiry Into Continental Illinois Corp. and Continental Illinois Nat'l Bank: Hearings Before the Subcomm. on Fin. Inst. Super., Reg. and Ins. of the House Comm. on Banking, Fin. and Urban Affairs*, 98th Cong., 2d Sess. 169-394 (1984); Carrington, *U.S. Won't Let 11 Biggest Banks in Nation Fail*, Wall St. J., Sept. 20, 1984, at 2, col. 2.

106. See Baer & Brewer, *Uninsured Deposits as a Source of Market Discipline: Some New Evidence*, 10 ECON. PERSPECT. (Sept.-Oct. 1986); Kaufman, *infra* note 113.

107. See Harris, Scott & Sinkey, *The Wealth Effects of Regulation Intervention Surrounding the Bailout of Continental Illinois*, in BANK CONFERENCE, *supra* note 6, at 104 (reporting that 11 largest banks had major stock price increases and the next smaller banks had price declines following public disclosure of the bailout policy).

108. Estimates of recent bailouts run into the billions. See Apar & Taylor, *Texas Thrift Rescue to Cost U.S. \$5.5 Billion*, Wall St. J., Aug. 22, 1988, at 3, col. 1; Apar, *First Republic Bank Bailout May Damage Capital Raising Efforts of Other Banks*, Wall St. J., Aug. 1, 1988, at 3, col. 1. Cf. Hilder, *Thrift Industry Crisis May Force Overhaul of Deposit Insurance*, Wall St. J., July 27, 1988, at 1, col. 6.

109. Hostile takeovers of large banks are possible. The recent effort of Bank of New York to takeover Irving Trust is illustrative. See *The Bank of N.Y. Co., Inc.*, 74 Fed. Res. Bull. 257 (1988). But the prolonged, costly, and highly regulated fight illustrates how difficult such a project is.

110. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

111. See Phillis & Pavel, *supra* note 31, at 23.

competition will provide a substitute for the threat of acquisition as a control over management.¹¹²

There are also supervision and insurance risks that result from large banks making major loans over very wide areas.¹¹³ It is obviously more difficult and costly for a regulator to be sure that a bank's operation has been fully audited and evaluated. Yet regulators must do this, particularly after having given banks the guarantee of invulnerability from failure and liquidation. In addition, banks have shown a distressing proclivity to make large amounts of loans to foreign governments of dubious creditworthiness and large enterprises of similarly questionable character. Additionally, the banks are unable to make good credit judgments when buying loans.¹¹⁴ All of this is explicable as rational behavior by inefficient enterprises which are taking excessive risks in order to secure reasonable earnings. Clearly, if the present system of guaranteed survival is to continue, the degree of regulatory control over lending decisions by major banks will have to increase. This is likely to be costly in direct terms and in its stultifying effect on managerial initiative.¹¹⁵

Finally, the Continental Illinois crisis and the crisis in Texas banking show that when large banks get in trouble, it is very costly to bail them out.¹¹⁶ The very limited capital in major banks means that the insurance system is not only the primary investor, but also the involuntary investor of last resort in bailout cases. Therefore, as more protected banks come into existence through large, interstate combinations, the taxpayers generally will have to spend more to bail out the large banks which get in trouble.

In sum, there will be efficiency and regulatory costs involved in allowing large banks to come into existence. Because large banks do not pay these regulatory costs, these expenses do not directly effect the decision of banks to consolidate. The direct efficiency costs, on the other hand, should deter interstate combinations. The fact that these efficiency costs do not deter large combinations is puzzling. In part, the answer is, as the next two subparts will show, that large banks can achieve nonefficiency, exploitative gains which may, in private economic terms, fully offset efficiency costs. Secondly, as will be discussed in Part IV, other pressures may work to cause individual bank managements to fail to make economically rational choices.

112. Lest the irony of suggesting that direct competition is a mere substitute for a more important, but indirect, stimuli to efficiency escape attention, I note here that in any economically rational world, the order of priority would be the reverse.

113. Kaufman, *Banking Risk in Historical Perspective*, in BANK CONFERENCE, *supra* note 6, at 231, 237-42; cf. N. STRUNK & F. CASE, *WHERE DEREGULATION WENT WRONG: A LOOK AT THE CAUSES BEHIND SAVINGS AND LOAN FAILURES IN THE 1980's* (1988).

114. A major part of the problems of major banks including Bank of America, Continental Illinois, the large Texas banks as a group, and even such traditional banks as Mellon, has been persistent bad lending decisions. *See, e.g.*, Helyar, *Hard Charging NCBN Seizes a Large Share of Banking in Texas*, *Wall St. J.*, Aug. 1, 1988, at 1, col. 6; Mitchell, *supra* note 60; Thurow, *America's Banks In Crisis*, *N.Y. Times*, Sept. 23, 1984 (Magazine), at 48, col. 1.

115. Cf. A. MARTIN, *ENTERPRISE DENIED* (1971) (study of the decline of American railroads attributing their fate to the effects of regulation which, inter alia, focussed managers on regulatory-political issues rather than efficient railroad operation).

116. *See* Apar, *First Republic Bailout May Damage Capital-Raising Efforts by Other Banks*, *Wall St. J.*, Aug. 1, 1988, at 3, col. 1 (FDIC to put in \$4 billion to bailout First Republic); Solomar, *A Burst of Bailouts*, *NAT'L J.* 2315 (Sept. 27, 1986) (Continental Illinois bailout alone cost over \$600 million).

Moreover, for reasons already indicated, the disciplines of failure and takeover do not provide effective restraints on management decisions.

B. *Competitive Costs as Traditionally Defined*

Competition in banking has proven to be beneficial, as economic theory and general experience had predicted.¹¹⁷ There is debate, of course, as to how much of a role competition policy has played in stimulating and promoting the growth and development of banking, but no one disputes that competition itself has played a key role. Former Chairman Volcker and leading bankers endorse competition as vital to the efficient and effective operation of our banking system.¹¹⁸ Therefore, if mergers between large banks in different states cause a loss of competition, this creates another potential social cost. This subpart will focus on the traditional competitive risks posed by such combinations.

1. *The Loss of Actual and Potential Competition*

When two large banks combine, the result is a single bank where previously there had been two viable banks. The merger eliminates the benefits that arise from diversity and choice.¹¹⁹ By definition, the individual banks were able to compete in each other's territory through such alternatives as opening a nonbank office, chartering a new bank, or acquiring a small or middle-sized bank. Despite the expressed antipathy of large banks for such alternate means of entry, some major banks have employed these routes.¹²⁰ Thus, the strategy being critiqued here is that of combining a large bank with a dominant bank in a local market when the world of interstate bank ownership permits many other entry means which are both legally available and employed.

The key traditional measures of competitive loss are the reduction in actual and potential competition in the affected markets. Large banks, especially those in the multibillion dollar range, directly and indirectly compete in commercial lending throughout much of the country. These large banks compete for loans by offering loans directly to large borrowers and by buying loans from originating banks.¹²¹ Hence, the combination of any two large banks reduces direct competition for loan placement within the national loan market. Large banks can also compete, directly or through correspondents, by providing a number of deposit services for large

117. See articles cited *supra* notes 6, 46.

118. See generally *Bank Hearings*, *supra* note 5.

119. Professor Loescher has emphasized the broader ways in which economically independent enterprises compete as a basis for an even more general prohibition of major mergers. Loescher, *Toward More Competitive Diversity in a Market Concentrated Economy*, in *CORPORATIONS AND SOCIETY* 263 (W. Samuels & A. Miller eds. 1987). See also Carstensen & Questal, *The Use of Section 5 of the Federal Trade Commission Act to Attack Large Conglomerate Mergers*, 63 *CORNELL L. REV.* 841 (1978); Dorsey, *Free Enterprise vs. The Entrepreneur: Redefining the Entities Subject to the Antitrust Laws*, 125 *U. PENN. L. REV.* 1244 (1977).

120. See *Bank Hearings*, *supra* note 5, at 310-11; for examples of entry, see cases cited *supra* note 53.

121. For examples of unsuccessful lending of both types see B. MARSH, *CORPORATE TRAGEDY: THE AGONY OF INTERNATIONAL HARVESTER COMPANY* 244-47 (1985); M. SINGER, *FUNNY MONEY: THE WONDROUS TALE OF PENN SQUARE BANK* (1985).

customers. Leading banks in any area or region are the most likely to provide such services as well. Therefore, the more geographically proximate the combining banks, the more likely they are to be in substantial direct competition for large and medium sized corporate business of all kinds. Rarely, however, has the Board reported or analyzed the data on this aspect of competition.

The Board opinions approving interstate combinations do reveal that large banks already often compete in each other's territory for consumer credit, mortgage lending, and other primarily consumer-oriented banking business.¹²² In fact, through credit cards and consumer finance affiliates, many major banks already offer a wide range of consumer finance services in broad geographic areas. Hence, the combination of large banks is very likely to eliminate some actual as well as potential competition in a wide range of consumer financial services.

One might argue, as the Board does, that the competitive losses resulting from mergers among large banking organizations are minor.¹²³ Nevertheless, they are losses. Moreover, bankers and the Board agree that competition is vital to maintaining efficiency. Consequently, if competition is being sacrificed for no gain to any other public interest objective, there is a net social loss, however minor.

The loss to competitive potential is even more certain. While the federal government has never fared well in court in challenging bank mergers on potential competition grounds,¹²⁴ the historic record is striking. More often than not, when such mergers were blocked, at least one of the parties made entry into the other's market within a reasonable time.¹²⁵ Interstate banking opens the door to entry level expansion into any market which offers promise of profit. The increased risk that entry will occur if the existing banks in a market fail to provide high levels of service and reasonable prices can be an important factor in making potentially oligopolistic markets perform efficiently and competitively. The potential contestability of a market can substitute for actual competition.¹²⁶ The more contestable a market is, the more existing enterprises will have to behave in competitive ways.¹²⁷ Indeed, this is a primary argument advanced to justify interstate bank ownership. However, interstate ownership can only achieve this competitive effect if the entry occurs by foothold or de novo means.

Interestingly, proponents of interstate banking suggest that large interstate bank mergers are a response to the increasing vigor of competition in many of their

122. See, e.g., Banc One Corp., 74 Fed. Res. Bull. 174, 176 (1988); Security Pacific Corp., 73 Fed. Res. Bull. 746, 747 (1987); Chemical N.Y. Corp., 73 Fed. Res. Bull. 378, 379 n.5 (1987).

123. See, e.g., Security Pacific Corp., 73 Fed. Res. Bull. 74, 74 (1987).

124. United States v. Marine Bancorp., 418 U.S. 602 (1974).

125. Halbrook & Savage, *Interstate Commercial Banking: The Antitrust Issues*, 98 BANKING L.J. 747, 762-63 (1981); Rhodes, *The Impact of Bank Mergers and Laws on Statewide Banking Structure*, 25 ANTITRUST BULL. 377 (1980).

126. See W. BAUMOL, *CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE* (1983).

127. Interstate banking increases the number of potential entrants not subject to intermarket interdependency. However, it is probable that large entrants will have some existing connections in the target market which may facilitate entry and make them more effective competitors. This combination of factors should spur entry into economically attractive local banking markets and should make such markets more contestable. These contestability considerations are different from those suggested by Baumol, but rest on the same fundamental proposition that market behavior will vary with the actual or perceived risks of effective entry. See W. BAUMOL, *supra* note 126.

historically protected market areas. This competition has arisen without the benefit of interstate bank ownership. Allowing interstate ownership thus may not perfect competition, but permit the acquisition of potentially protected, dominant market positions, deposit bases less subject to competition, or other marginal advantages for established but not very efficient banks struggling to survive.¹²⁸ In sum, the objective of major interstate bank consolidation is to make banking market positions less contestable, not more contestable.

2. *Linked Oligopoly*

In an article published in 1970, Eleanor Solomon suggested that if firms have positions in two or more geographically distinct oligopoly markets, the incentive to compete vigorously in any one of these markets will be reduced or eliminated because such competition will induce competitive counterattacks in the other markets in which the same banks compete.¹²⁹ Hence, when the same banking organizations participate in several oligopolies, even if their shares in some are small, the links between oligopolistic markets create a deterrent to vigorous competition.

Historically, the structure of American banking was consistent with the above theory. The observed behavior of oligopoly banks suggested that they did respond to each other in ways consistent with the theory. A relatively small set of money center banks dealt with each other regularly on large loans and had a clear community of interest which would lead to reciprocal restraint in their competition.¹³⁰ The growth of regional banks has put a great deal of strain on this small set of banks. The regionals are not bound to the group rules in the same way; regionals are less interdependent within the context of interstate lending.¹³¹ In short, they have fewer links to the established national banking fraternity. On the other hand, regional banks are often nurtured in a local or state market context in which legal and other institutional limits create similar local or statewide interdependency with respect to more localized business.¹³²

The effect of combinations among banks from these two sets of oligopolies will be to increase greatly the links among all specific oligopolistic markets. This effect will reduce the incentives for more competitively oriented banking behavior in any particular market. The enthusiasm of large regional banks for interstate bank

128. Buynak, *Interstate Banking: Its Impact on Ohio Banks*, ECON. COMMENTARY (Fed. Res. Bank of Cleveland, Sept. 15, 1985); Phillis & Pavel, *supra* note 31, at 23.

129. Solomon, *Bank Merger Policies and Problems: A Linkage Theory of Oligopoly*, 2 J. MONEY CREDIT & BANKING 323 (1970).

130. As long as each bank could trust the other not to compete, rates could be maintained in various submarkets. As a matter of game theory, this is a type of "prisoner's dilemma" situation. Recent research has shown that stable, anticompetitive, i.e., collusive, results can be achieved by using simple strategies. See R. AXELROD, *THE EVOLUTION OF COOPERATION* (1984).

131. A good illustration has come in the different responses of the two types of banks to the problems of foreign debts gone bad. See, e.g., Guenther, *Some Regional Banks Grow Rapidly, Reach Major-League Status*, Wall St. J., Oct. 1, 1987, at 1, col. 6.

132. See Joint Appendix in *United States v. Marine Bancorp.*, 418 U.S. 602, app. at 1237-39, 1277-78 (1974) (cited in part in Rhodes, *supra* note 125, at 379 n.10); see also B. MARSH, *supra* note 121, at 263-64; cf. *In re Nat'l Tea Co.*, 69 F.T.C. 226 (1966).

combinations may simply reflect a desire to link oligopolies and recreate the less turbulent context of the past.¹³³

A similar problem will exist in more localized banking markets as leading banking organizations become major participants in multiple states. The incentive directly, or indirectly via correspondent relationships, to compete actively will diminish because each banking organization will have an increasing concern to avoid stimulating aggressive, retaliatory competition in the markets it dominates.

There is debate about the degree of competitive harm that linked oligopoly has created.¹³⁴ Few claim that oligopoly linkages have any positive competitive potential.¹³⁵ The only question is how harmful oligopoly linkages are to competition.¹³⁶ Major interstate bank combinations will only increase the risks that oligopoly linkages will reach the level of being measurably harmful to competition.

3. Entrenchment

In general, when a leading firm consolidates with another firm having substantial resources, the resulting entity has both an existing position and a greater ability to defend and protect that position.¹³⁷ The result is entrenchment of existing positions. Such enhanced economic capacity deters both existing competitors and potential new entrants from challenging the dominant firm, thereby reinforcing the existing structure in these markets.¹³⁸ Interstate combinations among large banks create entities with deeper pockets and with greater ability to occupy all available branch locations,¹³⁹ engage in costly advertising, and cut loan rates selectively.¹⁴⁰

133. The patterns reported in Part I of this Article are consistent with such a long run objective. Bank support for regional interstate banking and bans on the acquisition of new banks is also consistent with this theory. Cf. N. LAMEROUX, *THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS: 1890-1904* (1985) (the major merger wave in the 1890s was based largely on a desire to reduce or eliminate emerging economic competition).

134. See Heggstad & Rhodes, *Multi-Market Interdependence and Local Market Competition in Banking*, 73 *REV. ECON. STAT.* 458 (1978); Master, *The Effects of Multimarket Contact on Savings and Loan Behavior* (Research Paper No. 85-13, Fed. Res. Bank of Philadelphia, 1985); Rhodes & Heggstad, *Multimarket Interdependence and Performance in Banking: Two Tests*, 30 *ANTITRUST BULL.* 975 (1980); Whalen & Megel, *Rival Stock Price Reactions to Large BHC Acquisition Announcements: Evidence of Linked Oligopoly?* (Working Paper No. 8605, Fed. Res. Bank of Cleveland, 1986); Whitehead, *An Empirical Test of the Linked Oligopoly Theory: An Analysis of Florida Holding Companies*, in *CONFERENCE ON BANK STRUCT. AND COMP.* 119 (Fed. Res. Bank of Chicago, 1978).

135. Master and Whitehead report oligopolistic links had positive effects. But Whitehead was examining the very unconcentrated Florida market. Whalen and Megel found that as the number of links increase, the effect of the additional linkage decreased. Only Master's results are inconsistent with theory.

136. Rhodes and Heggstad suggest that the primary impact will occur after the merger movement has subsided. This was the experience earlier in manufacturing. See N. LAMEROUX, *supra* note 133.

137. See, e.g., *Proctor & Gamble, Inc. v. FTC*, 386 U.S. 568 (1967); *General Foods Corp. v. FTC*, 386 F.2d 936 (3d Cir. 1967), *cert. den.*, 391 U.S. 919 (1968). There has been a resurgence of academic interest in, and discussion of, these problems frequently employing the label "predation" rather than entrenchment. See Campbell, *Predation and Competition in Antitrust: The Case of Nonfungible Goods*, 87 *COLUM. L. REV.* 1625 (1987); Krattenmaker & Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 *YALE L.J.* 209 (1986); Salop & Scheffman, *Raising Rivals' Costs*, 73 *AM. ECON. REV. PAPERS AND PROC.* 267 (1983); Schmalensee, *Entry Deferral in the Ready-to-Eat Breakfast Cereal Industry*, 9 *BELL J. ECON.* 305 (1978).

138. Cf. Storts, *The Case for a Rational Banking System*, *CONFERENCE ON BANK STRUCT. AND COMP.* 35, 37 (Fed. Res. Bank of Chicago, Apr. 23-25, 1984).

139. *Industrial State Bank & Trust Co. v. Camp*, 284 F. Supp. 900 (W.D. Mich. 1968), *vacated as moot*, 421 F.2d 1361 (6th Cir. 1969).

140. The power to make such short-term selected discretionary uses of resources is a function of size and diversity

Of course, if a market is rapidly growing, entry and expansion may still occur; but in less dynamic circumstances, the risk is that entry and expansion will not be rational business conduct. The costs of success in such a slow growing market are not worth the expected gain. Experience indicates that the result of such entrenchment will be to reduce consumer welfare: prices will increase, the quantity and quality of services will deteriorate, and innovation will no longer have the same attraction.¹⁴¹

The logic of profit-seeking makes it very unlikely that a substantial bank will enter, either *de novo* or on a foothold basis, into a stable market in which the leading banks already have large partners. The costs and expected gains of competing in such contexts must be compared with the gain expected from alternative uses of the resources that might have been invested in such competition. Hence, the option of buying a dominant position in another market makes it unlikely that a major bank will undertake a more competitive alternative. In middle-size and smaller markets, only a handful of large bank affiliates will exist. Local markets generally will be more oligopolistic and less contestable.¹⁴² The evidence that affiliates of large banking organizations are no more effective as new entrants than are *de novo* banks and that both types of entry are successful may suggest that the risks of entrenchment are less substantial than they may appear.¹⁴³

4. Summary

This review shows that all the competitive risks traditionally examined in evaluating mergers exist. Although none of those risks are overwhelming, all are present.

C. Adverse Relational and Discretionary Power Effects

Traditional competitive policy analysis focuses on the price and output effects of conduct in broadly defined markets.¹⁴⁴ One characteristic of such an analytic perspective is that it ignores the more parochial and particular (relational) effects of economic actors on each other. A second characteristic is that this analytic perspective ignores much of the impact of discretionary power, *i.e.*, choices having economic effect on third parties but not involving market power. Large interstate bank combinations can create negative social costs in both relational and discretionary terms.

and not traditional profitability. Hence, the long run inefficiency of major banks is not relevant to their power to act in such ways in specific markets.

141. Cf. D. RAVENSCROFT & F. SCHERER, *MERGERS SELL-OFFS, AND ECONOMIC EFFICIENCY* (1987); Weiss, *Concentration and Price—A Progress Report*, in *ISSUES AFTER A CENTURY OF FEDERAL COMPETITION POLICY* 317 (R. Wills, J. Caswell & J. Culbertson eds. 1987).

142. These effects are very much reinforced by present policies of allowing horizontal mergers.

143. See Rose & Savage, *Interstate Banking and the Viability of Small, Independent Banks: Further Evidence on Market Share Accumulation by New Banks*, 32 *ANTITRUST BULL.* 1007 (1987).

144. See Carstensen, *Antitrust Law and the Paradigm of Industrial Organization*, 16 *U.C. DAVIS L. REV.* 487 (1983).

1. Relational Power Problems

Relational power involves the ability of one economic actor to exercise power over another as a result of the relationship between the parties.¹⁴⁵ Some relationships are the result of location, e.g., the nearest convenience store, or other geographic factors. Other relationships are of transactional or contractual origin. The relational power of franchisers, automobile manufacturers, and gasoline producers arises from their contractual power to control vital aspects of the next level of production or distribution. Other relational power can arise from market imperfections that make it difficult for the dependent party to take advantage of existing market opportunities. Various elements of consumer credit illustrate this form of relational power.¹⁴⁶

If a business has relational power over some class of customers or other parties with which it deals, it will be economically rational for the business to exploit that advantage to the fullest extent in order to obtain higher prices or provide lower levels of service to those specific parties.¹⁴⁷ It will also be a rational investment of the business' resources to seek to enhance and perfect such exploitative capacity. Conversely, maximizing the number of substitutes available minimizes the size of the groups and the degree of feasible exploitation.¹⁴⁸ Increasing the number of differentiated options increases the probability that specific parties will have reasonably good second choices, making the parties more willing to resist exploitative actions. This willingness to resist exploitative actions reduces the incentive to undertake the costly process of locating and exploiting relational power. The theory expressed here suggests that the number of independent choices will affect the degree of relational power, but will never eliminate it.

Banks have a substantial capacity to create and exploit relational power. A loan applicant in particular comes as a supplicant seeking funds. Would-be borrowers must make large-scale disclosure of their business and possibly their personal finances and must face the added costs of searching for additional credit sources if the would-be borrower rejects the bank's offer. Moreover, once the bank has established the credit line, customers find that they are now subject to the rights of the bank to call the loan or enforce whatever other rights the bank may have under the loan instrument.¹⁴⁹ Unless the competitive market context impels the bank to behave

145. There is a large literature in contract law about relational contracting. For a good introduction in the terms of competitive policy analysis, see Bohling, *Franchise Terminations Under the Sherman Act: Populism and Relational Power*, 53 TEX. L. REV. 1180 (1975); see also Carstensen, *supra* note 144, at 502-03.

146. See, e.g., Cooter & Rubin, *A Theory of Loss Allocation for Consumer Payments*, 66 TEX. L. REV. 63 (1987).

147. See materials cited *supra* note 60.

148. Williamson and Markovits both theorize that the degree of relational power is closely related to the cost of switching to the next best alternative. See O. WILLIAMSON, *MARKETS AND HIERARCHIES, ANALYSIS AND ANITRUST IMPLICATIONS: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION* (1975); Markovits, *Oligopolistic Pricing Suits, The Sherman Act and Economic Welfare*, (pts 1-4), 26 STAN. L. REV. 493, 717 (1974), 27 STAN. L. REV. 307 (1975), 28 STAN. L. REV. 45 (1975). The more alternatives that exist, the greater the likelihood that individual customers will have one or more reasonably good next best alternatives. The more good alternatives that exist, the harder it is to set a cohesive limit on competition.

149. The recent spate of successful lawsuits by borrowers shows the powerful nature of this relational power even in today's banking world. For a critical discussion of the leading cases see Granoff, *Emerging Theories of Lender Liability: Flawed Applications of Old Concepts*, 104 BANKING L.J. 492 (1987). See also Cappello, *The Lender-Liability Case*, TRIAL 88 (Nov. 1987).

reasonably, the bank's preference will be to allocate to itself powers to adjust the relationship in ways that are in the bank's best interest, but are not necessarily in the best interest of the other party or society in general.

Increased choice is, therefore, crucial to limiting the undesirable consequences of relational power. Combinations of large banks reduce the number of alternative credit sources, decreasing the chances of getting socially optimal systems for governing the relationship between the bank and its customers. More generally, as consumer choice decreases, the power of the bank in relation to its customers increases.¹⁵⁰ The incentives inherent in linked oligopoly reinforce these effects.

2. Discretionary Power

Discretionary power is the power of choice. Discretionary power exists in any economic situation and is of concern when it has substantial impact on social or economic aspects of society. As the number of decision-makers declines, the choices of each remaining decision-maker take on greater significance. If 1000 firms make locational decisions about factories, the nation need not be concerned. But if 10 or even 100 firms decide where all the factories in the nation will locate, then the social and economic impact of those choices will turn them into political decisions. Public review of some sort will be inevitable. The problem is not one of traditional market power abuse, but rather one in which the discretionary power of a few decision-makers has a vast impact on the social and economic order. It also follows that some classes of enterprise are more important than others because they have greater external social and economic impact. Many such businesses are directly regulated as to the scope and use of their discretion.¹⁵¹ Other businesses remain unregulated largely because their numbers are such that the case for controlling specific choices is not powerful.

Banking is an industry whose discretionary choices on both the macro and micro level have been the source of continuing social concern and regulation. It is manifest that banking will never be free from regulation over its use of discretion.¹⁵² But regulation can be a greater or lesser intrusion. As the number of banks exercising economically important discretion decreases, the political pressure for more public review of the use of their powers of choice increases. Therefore, the fewer the number of major banks, the greater is the social concern with how each bank exercises its discretion.

While a bank should presumably have substantial freedom to say whether or not any particular loan is worthwhile, that freedom implies a discretion which creates

150. The emerging law of lender liability suggests an alternative and costly way to police the use of relational power. Therefore, a likely consequence of the dramatic increases in the linkages among banks will be an increase in judicial review of cases involving exploitation of relational power.

151. These limits include traditional health, safety, and consumer protection concerns. *E.g.*, WIS. STAT. ANN. § 146.24 (West 1974) (regulation of milk quality); WIS. STAT. ANN. §§ 617.01-.23 (West 1980 & Supp. 1987) (regulation of insurance).

152. See Loring & Brundy, *supra* note 8; Wynne & Spagnole, *supra* note 8. See also *Financial Institutions Symposium*, 37 CATH. U.L. REV. 279 (1988).

social concern. If most banks elect, for example, not to make loans on inner city real estate, that decision creates strong pressures against the maintenance of a viable center city. Similarly, if banks elect, in their individual discretion, not to make certain types of business loans, then certain classes of business may not exist or will suffer comparative disadvantages in finance. The greater the number of alternatives open to prospective borrowers, the greater is the chance that any economically rational business transaction will find financial support. The relatively closed financial systems of Europe are a partial explanation of why European countries have never had the kind of entrepreneurial activity that the United States enjoys. Such entrepreneurship has also been a primary source of the United States' long run economic success.¹⁵³ Thus, interstate combinations of large banks threaten both to constrict the range of banks' discretionary choice and to create a political context in which more public control over discretionary choice will exist. Both consequences entail negative social costs.

Two other important aspects of discretionary power also deserve comment. First, banks are important users of skilled professional services. In particular, banks are important to the establishment and maintenance of major law and accounting firms. As the discretion to select lawyers, accountants, and other similar professional services moves upstream to a remote headquarters, leading local law, accounting, and similar professions face a reduction in the demand for their services. As a consequence, many localities will lose or have a reduced supply of the kind of highly skilled and experienced business counselors that are an important part of their social, economic, and political context. These individuals are an important part of the infrastructure of a robust and dynamic local economy.

Second, banks and their top executives have historically played vital roles in local social and political activity. Individual bankers make discretionary contributions of their time to the betterment of their communities. Equally important, individual bankers can command the financial resources of their bank to make contributions to the community both by providing charitable donations and by supporting a wide range of community development activities. If the bank ceases to be locally controlled, managers will be less likely to exercise their discretion to expend time on projects which bring local recognition yet lack support or recognition at corporate headquarters. Similarly, direct contributions and other assistance will now rest upon the discretion of corporate managers far removed from the locality, making such assistance less likely to occur. Both of these losses will impoverish society as a whole, even if they do not show up as a direct economic cost of allowing major bank combinations.

To sum up, interstate bank combinations affect the problem of discretionary power in two ways. First, interstate bank combinations reduce the number of discretionary actors in the national framework and the potential number of discretionary actors in local market contexts. The latter loss assumes that other means of entry exist. With fewer players, the costs of any one player making poor discretionary

153. *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 371 (1963); cf. *Dorsey*, *supra* note 119.

choices (poor from a social perspective) increase. Second, discretion must, in any large organization, be subject to internal control. Internal control is both necessary as a management device and vital to investor reliance on the business.¹⁵⁴ Internal control inevitably shifts the ultimate discretion to the top managers. The top managers will have their own agenda and values. The managers will shape the choices made and the options accepted and rejected. The result is that states that lack major bank headquarters will suffer losses relative to those states with major bank headquarters based on the exercise of this discretionary power.¹⁵⁵

3. *The Regulatory Costs of Relational and Discretionary Power*

Increased and increasingly visible relational and discretionary power create an added economic hazard. The overall political history of the United States reflects sustained hostility to significant and unregulated accumulations of such power.¹⁵⁶ As a result, conspicuous examples of relational power, such as franchise and dealership agreements, are now subject to direct legal control.¹⁵⁷ Similar controls exist over consumer credit.¹⁵⁸ Discretionary bank power has been used to discriminate among consumer credit applicants based on race or sex and to refuse credit for local development.¹⁵⁹ This discrimination has already produced a complex of laws, including the Community Reinvestment Act, which regulate the exercise of bank discretion.¹⁶⁰ Such discrimination has also facilitated the development of an emerging common law rule imposing liability on lenders for various kinds of misconduct.¹⁶¹

It is questionable, however, whether such increased regulatory intervention and control makes long run economic sense even if, as is often doubtful, it is sufficient to provide any effective limits to the use of discretionary power. Any legalistic control over the use of discretion is costly. Records must be retained and made accessible. Large amounts of the manager's time may have to be devoted to the claims process. All such costs ultimately become part of the cost of providing the service. Beyond direct costs are the more subtle conduct responses such reviews may produce. For example, rather than justify choices, managers may abandon an entire field. Alternatively, all those seeking a particular type of service will be forced to pay

154. Cf. Securities Exchange Act of 1934, § 13(a)(2), 15 U.S.C. § 78m(a)(2) (1982) (publicly held corporations must have accounting controls).

155. For example, as of June 30, 1985, Ohio banks alone owned more than 17% of Indiana bank deposits. See Buynak & McElravey, *Ohio Banks: Hitting the Interstate Acquisition Road*, ECON. COMMENTARY (Fed. Res. Bank of Cleveland, May 15, 1987). States such as Arizona, Delaware, Maine, Nevada, South Dakota, and Washington have a majority of banking assets controlled by out of state organizations. See Erdevig, *New Directions for Economic Development—The Banking Industry*, ECON. PERSPECTIVES No. 12, at 17, 23, Table 4 (Fed. Res. Bank of Chicago, Sept./Oct. 1988).

156. J. HURST, *LAW AND MARKETS IN UNITED STATES HISTORY* (1982).

157. See, e.g., Wisconsin Fair Dealership Law, WIS. STAT. ANN. § 135 (West 1985 & Supp. 1986); Automobile Dealer's Act, 15 U.S.C. §§ 1221–1225 (1982); Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801–2841 (1982).

158. See, e.g., 15 U.S.C. § 1691 (1982 & Supp. IV 1986) (forbidding discrimination in granting credit).

159. See Dedman, *Banks Lending \$20 Million in Low-Interest Mortgages*, Atlanta Journal-Constitution, June 19, 1988, at 1, col. 1 (Atlanta banks respond to exposure of discriminatory lending practices by creating a limited loan program).

160. 12 U.S.C. §§ 2901–2905 (1982).

161. See, e.g., *State Nat'l Bank of El Paso v. Farah Mfg. Co.*, 678 S.W.2d 661 (Tex. Ct. App. 1984).

higher prices for that service in order to cover the undifferentiated risks.¹⁶² Finally, such regulation is likely to rigidify the decision-maker's frame of reference and thereby reduce the opportunity to develop innovative solutions to problems.¹⁶³

D. Aggregate Concentration

The final cost of large bank combinations that has both a political and a long run economic aspect is the aggregate concentration of resources among fewer owners in the financial sector of the economy.

In addition to the direct cost of regulating discretionary and relational power already discussed, there is a broader negative political and ideological implication to the combinations of large banks. The United States has sought to preserve and maintain the ideal of an open society in which people and business have the opportunity to achieve their ambition with as little state intervention as possible. As the United States moves toward banking on a greater scale and, in consequence, imposes more direct regulation over the use of the relational and discretionary power of banking, that direct regulation will belie those claims to an open society in a very overt way. A select few, subject to government regulation, will set bank policies that will greatly affect financial conditions for entry and growth in all businesses. Indeed, even if there were no real loss of opportunity, the appearance of a loss—the lack of locally controlled lenders apparently willing to back new business—might precipitate and reinforce a political climate unsympathetic to the needs of banking and business generally. The risks run well beyond costly and stultifying regulation of banking itself. Increased aggregate concentration can stimulate a renewed pressure for wide-ranging, direct control of business decisions.¹⁶⁴ Because there are no significant gains to economic efficiency with an increase in aggregate concentration, there is no excuse for creating such political risks.

Two dynamic economic concerns arise from aggregate economic concentration. The first concern is innovation internal to the banking organization. The larger an institution, the more difficult the process of change and innovation. Large institutions, especially geographically dispersed ones, must put more filters and controls on innovation. It is a truism that large bureaucratic systems directly stifle innovative development of new methods, systems, and products. Hence, large interstate banks will have a hard time being consistently innovative.

Moreover, combinations of large banks directly reduce the number of substantial entities able to initiate and respond innovatively to opportunities. As fewer management committees control decisional power, the variance in experimentation is likely to decline with a consequent delay or failure to discover lower cost systems or a truly innovative product or service. The marginal experiment, which, for all we know, is the most important one of all, will not occur.

162. Cf. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521 (1987).

163. See generally B. KLEIN, *DYNAMIC ECONOMICS* (1977).

164. This is a long standing question in American political-economic policy. For example, President Theodore Roosevelt actively sought strong national control over large corporations as the necessary social limit on their use and abuse of power. See M. SKLAR, *THE CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM 1890-1916* (1988).

As banking resources become more focused in a limited set of institutions, the incentives to experiment over a broad range of options will decline. Large, geographically dispersed banks will focus on the problems that such organizations face. A solution that entails vertical or horizontal disintegration will be of no interest. Thus, reducing the diversity of financial institutions circumscribes the range of relevant innovations.

The second negative dynamic effect concerns society generally. A bank's incentives to support new business and take risks is in part a function of its structural security. Today, the very diversity of banks, their number and diffusion, insures that banks neither control economic development nor manage it. Banks respond to economic development and must find ways to serve their markets. As banking organizations become larger, more uniform and bureaucratic, in entrenched positions in static markets, tied to substantial existing clients, and lacking the pressure of actual and potential competition, they will cease to serve the economic best interests of the country as risk-taking lenders supporting new enterprise. They will, instead, increasingly act to control, entrench, and protect an established economic order. This is the role taken by German, English, French, and Japanese banks that reflects the much more concentrated character of those national banking markets.¹⁶⁵

E. Conclusion

This survey of the potential costs associated with the mergers of large banks suggests two important points. First, there are many potential social costs to such combinations. They include: traditional and nontraditional competitive concerns, increased regulatory burdens, and the efficiency cost of such combinations both in operating and dynamic terms. Second, these costs are cumulative. The presence of some types of costs will tend to cause other types of costs to emerge. Thus, even if no one cost appears overwhelmingly likely, or likely to be of great substance, the cumulative and interactive character of such costs means that their total effect will probably be greater than the sum of the specific impacts.

V. THE CHANCES OF LARGE MERGERS INVOLVING SOCIAL COSTS

If the foregoing analysis of negative effects is correct, why should we expect large bank combinations to continue to occur? Large bank combinations are unlikely to deliver on their promises of good things and are likely to involve inefficiency. Indeed, because some benefits are possible, can we predict that banks will act in a selective way so that only desirable mergers will occur? The simple answer is no. On an empirical basis, it seems very clear that the present trend will continue. This trend may reflect managerial or firm rivalry, or defensive strategy.¹⁶⁶ In any event, all indications are that such combinations will continue to occur on a substantial scale.

165. See Roth, *German Banks Maintain Corporate Grip*, Wall St. J., Sept. 30, 1987, at 32, col. 4.

166. Large banks, seeing their own markets invaded, may react by creating defensive alliances to respond to the perceived threat despite efficiency costs. See Staff, Davidson & McDonald, *supra* note 79; cf. Phillis & Pavel, *supra* note 31; Schlesinger, *GM Seeks to Buy A Sizable National Car Rental Stake*, Wall St. J., Aug. 8, 1988, at 4, col. 5.

This is less surprising if one recognizes that the private interest of banks and their managers is not necessarily congruent with the public interest. Public costs are often private gains. Hence, the private balance can be quite different from the public balance. Many contemporary economic thinkers deny or minimize this divergence. They assume that enterprises have as their only or primary objective improved allocative and productive economic efficiency.¹⁶⁷ Because such an objective is indeed consistent with social objectives, it is easy, given such an assumption, to conclude that only good mergers will occur.

But, in theory and in fact, business seeks profit and not efficiency. Therefore, decreased efficiency in production is not a deterrent to a course of conduct if it also creates sufficient disincentives for others to compete or blocks enough entry of new competition to make the long run balance of gain and loss favor the conduct.¹⁶⁸ Hence, so long as the expected private gains to corporate actors outweigh their expected costs, there is no economic deterrent to such a private course of conduct. Therefore, a combination having no positive, and possibly a negative, efficiency effect can still be valuable if it allows one or both parties to exploit any relational power over their customers more effectively. Even worse, merger may eliminate actual or potential competition, create or strengthen intermarket oligopolistic links, and entrench further oligopolistic power over classes of customers. Merger of leading banks is the most likely way in which all of these anticompetitive and socially undesirable effects will occur.¹⁶⁹ The premiums paid in such mergers may well reflect, at least in part, the value of such expected future market control.¹⁷⁰

There is an additional consideration that makes mergers possible despite their inefficiency. Shareholders in publicly traded banks are not able to police managers closely, and they cannot capture the full value of the enterprise as a going concern. Because a buyer of the enterprise acquires full control over it, the buyer will be able to extract all surplus value that the enterprise produces. Consequently, the buyer bank can afford to pay a premium over the market price of stock in the acquired bank because it will acquire the ability to capture the full value produced. This is the best explanation for the phenomenon of the "control premium" that is frequently observed in various types of corporate takeovers. Unlike explanations of takeover as evidence of the buyer's recognition of more efficient uses for the acquired assets,¹⁷¹ this explanation relies on the weak monitoring power of dispersed shareholders and explains observed premiums accordingly.¹⁷² This is an especially powerful explanation in the banking context because the many restrictions on changes in bank

167. See R. BORK, *ANTITRUST PARADOX* (1978); R. POSNER, *ANTITRUST LAW AND ECONOMICS* (1976); Easterbrook, *The Limits of Antitrust*, 63 *TEX. L. REV.* 1 (1984).

168. There is a very important recent literature developing this proposition. See *supra* note 137.

169. These effects may be the cumulative result of a set of mergers that will make it even harder to detect such consequences in any particular case.

170. See Phillis & Pavel, *supra* note 31.

171. This is the usual assumption that is uncritically adopted in analyses of takeovers. See, e.g., Babchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 *HARV. L. REV.* 1693, 1700-03 (1985).

172. Cf. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 *MICH. L. REV.* 1 (1986); Lowerstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 *COLUM. L. REV.* 249 (1983).

ownership make it hard for the market for corporate control to discipline management on a continuing basis.¹⁷³ Hence, even if there are efficiency costs to managing banks in several different states or regions, the buying bank can pay a premium over the market because, despite such costly monitoring, the buying bank will receive a higher yield as owner than existing shareholders.

VI. A COST-BENEFIT ANALYSIS OF LARGE BANK MERGERS

Banks are the creations of positive law and policy. Any system of money and credit is a construction of the legal system and would disintegrate without legal definition and enforcement.¹⁷⁴ When banks or other financial institutions exist, expand, merge, or dissolve, it is because the legal system authorizes that outcome. There is no "natural right" of banks to have some particular shape, character, or scope. A bank is what the law says it is. This point is important because it means that a decision either to expand or contract bank rights must rest on policy and not some abstraction of inherent rights.

A cost-benefit analysis is a basic policy tool that helps collect and weigh competing considerations. The basic test of such an analysis is whether the gains are worth the costs. While there are obvious and probably insuperable problems with rigorously establishing the values on either side of this kind of an equation, some general, probabilistic statements are possible. Moreover, express analysis of the cost-benefit balance, even if uncertain, sharpens the policy focus.

On the benefits side, the striking fact revealed above is that gains from large interstate combinations are unlikely to occur, unlikely to be truly public, *i.e.*, not otherwise achievable benefits, and unlikely to be substantial even if they do occur.¹⁷⁵ The few, easily identifiable, exceptions prove the strength of the generalization. The bulk of the positive arguments rests upon either unanalyzed ideas of inherent right and logical necessity, or upon a misapplication of valid claims, particularly the importance of competition.

On the negative side, interstate combinations of large banks are reasonably certain to create some costs. Most of the potential negative costs are the logical outcomes of the resulting structural changes that these combinations will produce. However, it is unlikely that the direct and identifiable elements of these costs will be very substantial. Despite the long list of risks set forth and described above, empirical studies rarely find substantial observed costs associated with such risks in the existing banking environment. However, some risks such as that of excessive inefficiency could create major costs in the future.

On balance, the benefits are slight at best and unlikely while the costs are much more likely but also probably slight.

173. See Helfer & Brummer, *Federal Banking Law Considerations in Unfriendly Takeovers of Depository Institutions*, 33 AM. U.L. REV. 309 (1984).

174. This is not to claim that law always controls the actual conduct of the business. See J. HURST, *A LEGAL HISTORY OF MONEY IN THE UNITED STATES, 1774-1970* (1973).

175. See Staff, Davidson & McDonald, *supra* note 79; cf. Miller, *supra* note 89.

Given such a general balance, those reviewing a particular bank combination could justify an initial presumption that the combination is objectionable. It would then be possible to rebut the initial presumption by making a specific showing that a modestly demanding test revealed that public benefits are reasonably likely. So long as the presumption is rebuttable, no merger which is reasonably likely to have positive effects would be blocked. However, an assessment of the claims of public benefit made in past large combinations, and the lack of either specific or general empirical support for those claims, would suggest that most proposed combinations could not overcome the initial presumption.¹⁷⁶

If, despite the balance struck here, decision-makers started with the opposite presumption, then almost all combinations would be accepted. Such a presumption of acceptability of the merger would be rebuttable as to any particular transaction. However, it is unlikely that the evidence as to most bank combination proposals would show the existence of potential negative effects at any level of substantiality even if it is conceded that such effects may occur.¹⁷⁷ The central implication of this analysis is that approval or disapproval of the bank combination, in most cases, will depend upon the initial presumption of the decision-maker and not upon the merits of the particular case. Therefore, the choice of initial presumption is crucial.

There is a traditionally strong basis for a presumption that allows any bank combination to which the parties have consented. Notions of economic and enterprise freedom are at the core of such a presumption. The abstract right of freedom of action is often justified on the pragmatic grounds that bank combinations are necessary for the essential growth of banking enterprises and for the achievement of social advantages. Such pragmatic claims are questionable in light of the information presented above. The general value of avoiding unnecessary interference with the decisions of business also exists. Any interference imposes regulatory costs and denies to the economy whatever serendipitous benefits may arise.

On the other hand, given the legalistic nature of banking and the fact that merger review will have to occur in any event, the regulatory cost savings resulting from electing one presumption over the other is marginal at best. Similarly, the claim of freedom to alter the geographic scope and scale of a banking enterprise by combination flies in the face of the general social policy and legal reality that positive legal authority is necessary to define what a bank may be and do. Freedom of action is accorded only when it has demonstrable instrumental value. Hence, the arguments for a presumption of nonintervention are not strong.

In contrast, three types of arguments favor a presumption against large combinations. First, there is a statutory argument. Congress has required, in all bank merger legislation, that there be positive benefits to justify the combination.¹⁷⁸ This

176. For an analysis of typical claims made in such large bank combinations, see Carstensen II, *supra* note 65, at 582-88. See also Allardice, *supra* note 71 (reporting very limited actual implementation of proposed new activities).

177. Those defending unconstrained interstate bank combinations rely heavily on this type of analysis and argument. See, e.g., Cohen, *supra* note 88; Miller, *supra* note 43.

178. See, e.g., 12 U.S.C. § 1842(c)(2) (1982).

consistent requirement suggests an underlying policy or value choice that rejects unconstrained freedom of action for banks.¹⁷⁹

A second consideration is the combination process itself. In the usual situation, a bank combination is a nonadversarial, largely *ex parte* proceeding in which the banks are the only parties actively collecting and presenting information. Such information is subject to potentially extensive staff review and even outside comment. Yet, the process would require a radical and costly change if agency staff or third parties were to litigate issues regularly. Hence, putting the burden on the merging banks to identify the potential gains and offer convincing evidence that such gains will occur will facilitate critical review of the merits of proposals. The knowledge that such a requirement exists will allow private parties to determine directly whether it makes sense to proceed. In effect, private parties can internalize the public interest concerns into their business expansion plans. Such internalizing should limit the overall direct regulatory costs.

Finally, in any decision of this sort, a key question concerns the fundamental policy goals that should be sought. There are no scientific or logical solutions to the choice problem. It is a matter of values.¹⁸⁰ There are three values which point toward the choice of a presumption against such combinations.

First, a presumption against interstate combinations of large banks is not a major intrusion on the choices of existing banking organizations. These organizations would have the right to expand into other states and to do so by acquisition. Only major acquisitions by major entities would be foreclosed.

Second, and closely related, the means of entry permitted will most likely stimulate the most positive contribution of interstate banking: increased competition. Hence, the limitation will reinforce the public advantages that such expanded powers make possible.

Third, a long run economic dynamic consideration follows closely from the expectation that expansion will occur despite the presumption against bank combinations. More actual and potential participants in the market are always preferable to fewer. More actors means a greater variety of decision-makers and more opportunity for experiment and innovation.¹⁸¹ Indeed, given its strong reliance on the competitive market, public policy should never needlessly sacrifice a viable competitor.

In addition, there is the social and political philosophy of democracy, particularly American democracy, which holds that unnecessary size is undesirable.¹⁸² This value also points toward a requirement that those proposing large-scale combinations

179. For example, interlocking directorships among large banks not owned in common are forbidden regardless of how directly they compete. 12 U.S.C. §§ 3201-3207 (1982). See Carstensen II, *supra* note 65, at 592-94. Cf. Holland, *\$500 Million Limitation BHC Acquisitions?*, 97 BANKING L.J. 884 (1980).

180. For a useful analysis of the role of values in legal scholarship and policy analysis, see Rubin, *The Practice and Discourse of Legal Scholarship*, 86 MICH. L. REV. 1835 (1988).

181. This is the model of the perfectly competitive market. While no one expects banking to become perfectly competitive, anything that moves its structure in that direction should be positive. See Dorsey, *supra* note 119; Loescher, *supra* note 119; cf. W. BALDWIN, *ANTITRUST AND THE CHANGING CORPORATION* (1961).

182. See J. HURST, *supra* note 156.

establish that such combinations are reasonably necessary to achieve real and otherwise unachievable social values.

The values justifying a negative presumption limiting large bank combinations are more persuasive in this context than the counter considerations. The key objection to interstate combinations of major banks remains the total lack of any convincing, general advantage to the economy resulting from such combinations. Conceding that the case for serious economic risks is not powerful, this argument still has more substance and more adequately explains when and why interstate combinations of large banks occur despite their neutral or negative efficiency than do any or all of the social advantage arguments. On balance, interstate combinations of large banks are socially undesirable and should be at least presumptively unlawful.¹⁸³

VII. LEGAL ALTERNATIVES TO CONTROL LARGE COMBINATIONS

Assuming a policy decision that large interstate mergers should be presumptively objectionable, the next question is how to implement such a policy. There are four ways in which this could be done. Two would involve new legislation, while the remaining two would involve reactivating existing legal controls which have fallen into disuse.

A. *New Legislation*

First, Congress could adopt limits on permissible bank mergers. The 1985 House Banking Committee Bill is one example.¹⁸⁴ The bill would have barred combinations among the twenty-five largest banking organizations and would have barred major acquisitions by any organization with more than one percent of all bank deposits in the country. On the basis of the analysis presented in this Article, such prohibitions could be further extended to create a presumption against the acquisition of any bank with more than one billion dollars in assets by any other banking organization having more than four or five billion dollars in assets. Alternatively, combinations between banks having more than five percent of the total deposits in any state could be forbidden.¹⁸⁵

There is an advantage to a simple command; it precludes a great deal of costly effort to avoid its terms. The very simplicity of such legislation creates a countervailing problem: fitting the command to the relevant facts. Banking structure in the

183. Three distinguished and experienced banking economists have supported a similar position. Halbrook & Savage, *Interstate Commercial Banking: The Antitrust Issues*, 98 *BANKING L.J.* 747 (1981); Shull, *Interstate Banking and Antitrust Laws: History of Public Policies to Promote Banking Competition*, 6 *CONTEMP. POL'Y ISSUES* 24 (1988). In addition, when he was a law professor, Judge Ginsberg, who has also served as Assistant Attorney General for Antitrust in the Reagan administration, endorsed an analogous policy toward major bank combinations. Ginsberg, *supra* note 87, at 1341-55.

184. H.R. REP. No. 2707, 99th Cong., 1st Sess. (1985); *see also Depository Institutions Acquisition Act of 1985*, H.R. REP. No. 99-174, 99th Cong., 1st Sess. (1985).

185. These limits are closer to, but not as low as, those used to bar interlocking directors. *See* 12 U.S.C. §§ 3201-3207 (1982). Shull suggests that regulatory barriers to new entry (chartering) should be reduced and that large bank combinations generally be forbidden. *See* Shull, *supra* note 183; Halbrook and Savage similarly recommend a ban on mergers. *See* Halbrook & Savage, *supra* note 183. Ginsberg supports a similar policy. *See* Ginsberg, *supra* note 183, at 1355-57.

United States is very diverse. A four or five billion dollar bank may be neither large nor powerful in California or New York, but may well be both in Colorado or Wisconsin. Thus, there are problems with the use of an asset size criterion. There is also a problem in adjusting the size limit to take account of inflation. Nevertheless, such a limit would leave open most expansion options by precluding only one type of acquisition.

State share measures are perhaps better criteria. But even they can fail to distinguish between a situation in which a six percent bank is also the largest bank in the state and a situation in which a six percent bank ranks lower in the state but its overall structure is more concentrated. Moreover, there is the highly difficult problem of which deposits to include. In some states, savings institutions and credit unions are very effective competitors. In other states (and for particular classes of business), savings institutions and credit unions are not very important alternatives.¹⁸⁶

Finally, congressional limits on permissible bank mergers would also have to permit reasonable regulatory discretion to approve the infrequent, but socially valuable combination. Otherwise, congressional limits would be unduly restrictive in terms of the policy arguments made above.

The second legislative alternative exists at the state level. In authorizing interstate bank ownership, the states can (and several have) restrict who may engage in interstate bank ownership or otherwise reasonably condition participation.¹⁸⁷ For example, nonresident banking organizations above a specific size limit could enter the state only by de novo means or by acquisition of banking resources below a specific threshold.

There are potential constitutional and implementational problems with state statutes.¹⁸⁸ These laws may not bind all banks as to all types of subsequent acquisitions, especially if the resulting bank has a national charter.¹⁸⁹ Crucial to this question is the scope of state branching law and bank holding company controls. When New York regulated bank expansion within the state, New York required that all interdistrict combinations take the holding company form.¹⁹⁰ Under national holding company law, the states have joint plenary power to review all such proposed

186. See Kintner & Bauer, *Competition at the Teller's Window?: Altered Antitrust Standards for Banks and Other Financial Institutions*, 35 U. KAN. L. REV. 657, 669-73 (1987).

187. A recent study of state laws identified six states with various limits on acquisitions all based on deposit shares: Indiana—12%, Iowa—8%, New Jersey—13.5%, Ohio—20%, Texas—25%, W. Vir.—20%. See R. JONES & B. PULS, *supra* note 1.

188. On the constitutional issues compare *Independent Commun. Bankers Ass'n v. Board of Gov. of the Fed. Res. Sys.*, 838 F.2d 969 (8th Cir. 1988) with *Independent Commun. Bankers Ass'n v. Board of Gov. of the Fed. Res. Sys.*, 820 F.2d 428 (D.C. Cir. 1987).

189. National banks are largely immune from state regulation. Hence, a nonresident banking organization can enter a state by acquiring a bank, convert it to national charter, and then merge other banks into that bank largely free from state control. See, e.g., *Ramapo Bank v. Camp*, 425 F.2d 333 (3d Cir.), *cert. denied*, 400 U.S. 828 (1970); *Volunteer State Bank v. National Bank of Commerce*, 684 F. Supp. 964 (M.D. Tenn. 1988).

190. Until 1976 the State of New York was divided into banking districts. Banks could branch within a district, but only holding companies could own banks in different districts. Because national banks' right to branch is subject only to the comptroller's review, 12 U.S.C. § 36, New York acquired plenary review power by forcing those interdistrict combinations that it wanted to review into the holding company form. See N.Y. BANKING CODE § 105 (McKinney 1971 & Supp. 1988).

combinations.¹⁹¹ Hence, even if a national charter were involved, the state banking authority retains a right to review in order to insure that no unacceptable combinations would occur. To implement fully such controls at the state level would require that the state establish comparable limits on intrastate combinations. The state could then enforce those limits as to acquisitions by all holding companies. However, national banks in such a state which were not part of a holding company still might escape state control as to mergers or branching.¹⁹² This lack of state control over nonholding company banks would restrict the effectiveness of any state effort to limit concentration. Given the trends toward use of the holding company device, however, it is unclear how many banks would escape regulation. Nevertheless, state legislative control would inevitably have some limitations.

B. Existing Controls

Perhaps the best alternative to new legislation would be to revive the "convenience and needs" criterion of the Bank Holding Company Act.¹⁹³ Because most interstate bank combinations involve holding companies, the Board has exclusive review power at the national bank regulatory level. Technically, interstate combinations by large banks must already satisfy the convenience and needs criterion. However, the meaning of that standard has been misunderstood and misapplied.¹⁹⁴ Properly understood, the convenience and needs criterion makes preservation of competition an important factor and requires employing the least anticompetitive alternative to achieve any socially desirable banking objective. Thus understood, the convenience and needs criterion itself creates a presumption against bank combinations which have any potential negative effects unless the specific combination also has offsetting positive effects.

Based on the analysis of large bank combinations offered above, the consistent and rigorous use of that approach to convenience and needs would impel the Board to reject most proposed combinations and to permit them only in special circumstances. Such a standard must, unlike past practice, be consistently employed.¹⁹⁵ Despite the way in which the Board has interpreted the convenience and needs criterion in the past, this criterion is not discretionary, but rather has a single clear command that must be uniformly applied in all cases.

The final existing means to control bank combinations would be through revival

191. 12 U.S.C. § 1842(b) (1982); *but see* the decisions on South Dakota banking law, *supra* note 188.

192. It is clear that the comptroller alone implements any applicable state limits. 12 U.S.C. § 36 (1982). While it is generally assumed that absent specific national law authorizing combinations or branches not permitted by state law (*see, e.g.*, 12 U.S.C. § 81 (1982), permitting relocation of headquarters), § 36 would limit branching rights and so indirectly limit combinations resulting in branches where the assets of the resulting bank exceeded the state limit. *Cf. Carstensen I, supra* note 39, at 1118-25.

193. 12 U.S.C. §§ 1841-1850 (1982 & Supp. IV 1986).

194. Carstensen II, *supra* note 65; *see also* Carstensen I, *supra* note 39. Halbrook and Savage suggest revising the convenience and needs criterion to make more express the negative presumption against large bank combinations. Halbrook & Savage, *supra* note 183.

195. The Board and the FDIC have in the past occasionally employed the convenience and needs or competitive effects criterion in this way. Neither agency, however, has adopted such an approach on a consistent and general basis. *See* Carstensen II, *supra* note 65.

of the antitrust laws: Section 7 of the Clayton Act¹⁹⁶ or Section 1 of the Sherman Act.¹⁹⁷ The Clayton Act's prohibition of mergers, which "may substantially lessen competition or tend to create a monopoly,"¹⁹⁸ would, given generous judicial interpretation, justify a court in forbidding those interstate mergers among large banks which lacked specific justification. Such a construction would, however, require either that the courts take a less structural view of some of the competitive issues in merger analysis, or introduce a more express balancing test in which the risks, however minor, to competition are balanced against the expected gains to efficiency or other social values.¹⁹⁹ When gains are unlikely, then even minor losses to competition may be "substantial" because of the lack of a plausible offsetting gain.

Perhaps a better route for the antitrust analysis is through the prohibitions on restraints of trade articulated in Section 1 of the Sherman Act. This section says that "combinations, in the form of trust or otherwise" in restraint of trade are illegal.²⁰⁰ A bank holding company acquisition is such a combination.

The legal standards for applying the Sherman Act balance any elimination of competition against any efficiency gain. Moreover, the statutory history and language make clear that Congress preferred competition. Hence, the presumption is that a combination restraining trade is illegal unless it can overcome that presumption.²⁰¹ Because large bank combinations, by definition, eliminate all actual and potential competition among the parties, such combinations restrain trade to some degree. Moreover, such restraints will have some negative effect, however minor, on the overall competitive context and are unlikely to have positive effects. As a result, the Sherman Act analysis would hold bank combinations illegal except when there is reasonable probability of a demonstrable and otherwise unachievable positive effect in a particular case.

This analysis has already received judicial approval in the context of large bank combinations in which the Clayton Act's criteria were not directly violated. The leading case involves the merger which produced Manufacturers Hanover Trust.²⁰² Congress voided the court's finding of illegality in *Hanover Trust* by grandfathering all consummated mergers.²⁰³ Yet the Bank Merger Act that achieved this result

196. 15 U.S.C. § 18 (1982).

197. 15 U.S.C. § 1 (1982).

198. 15 U.S.C. § 18 (1982).

199. See Halbrook & Savage, *supra* note 183, at 763.

200. 15 U.S.C. § 1 (1982).

201. Section 1 of the Sherman Act states that "every" combination in restraint of trade is illegal. 15 U.S.C. § 1 (1982). The rule of reason has modified this standard. See *Standard Oil v. United States*, 221 U.S. 1 (1911). The logic of statutory construction would seem to imply that Congress has clearly made competition the prior policy goal. See *United States v. Trenton Potteries*, 226 U.S. 597 (1923); see also *National Gerimedical Hosp. & Gerontology Center v. Blue Cross*, 452 U.S. 378, 388-89 (1981), *Denver & R.G.W. v. United States*, 387 U.S. 485, 498 (1967); cf. *WIS. STAT. ANN.* § 133.01 (West 1974) (declaring competition is preferred state policy). But see Arthur, *Farewell to the Sea of Doubt: Jettisoning the Constitutional Sherman Act*, 74 CAL. L. REV. 266 (1986) (suggesting a different balance).

202. *United States v. Manufacturers Hanover Trust Co.*, 240 F. Supp. 867 (S.D.N.Y. 1965).

203. See 12 U.S.C. § 1842(c) (1982).

may also be interpreted as adopting the Sherman Act standards laid down in *Hanover Trust* for future bank combinations.²⁰⁴

C. Summary

This Part provides only a brief summary of the available means for implementing a policy of prohibiting large interstate bank combinations. Each option entails many particular problems of articulating the appropriate rules and of defining effective means of implementation, including the problem of determining how exceptional cases would be defined and proven. It is worthwhile to pursue those technical issues only if the policy judgment is first made that such combinations should be restricted.

VIII. CONCLUSION

One should not be optimistic that policy makers will think critically about controlling the nature of interstate bank combinations. Too many policy makers believe in the superiority of the large firm despite being surrounded in banking, retailing, manufacturing, academia, and government by realities that contradict such mythology. If the policy makers are wrong about the inherent efficiency of such banks, and the evidence points that way, then they are building a banking system that will eventually require either protection from substitutes, new entrants, and others who might threaten its fragile hold on economic survival, or a massive, government financed restructuring. In a couple of decades, one can expect to hear bankers telling Congress about the need to protect our banking system from competition in the same way as the overly concentrated, inefficient steel and auto industries are now doing. When we hear those calls for help we will know that the wrong policy choices were made, but by then, it will be too late.

204. See Carstensen II, *supra* note 65, at 590.

