

FEDERAL RESERVE BANK OF PHILADELPHIA

# Potential Competition and the Banks

By Timothy Hannan\*

Competition is the first line of defense against high prices and poor service. The more competitive a market is, the more likely it is to offer relatively high grades of goods and services at relatively low prices. This maxim applies to a regulated industry like banking just as it does to any other form of commercial endeavor. Faced with a host of competitors, a bank has to convince customers that the services it provides are somehow superior to those offered by other banks. With fewer competitors, this pressure is reduced.

Regulation of mergers is one of the chief tools that policymakers use to encourage competition. The name of the game here is to keep major banks in the same market from merging with one another if the merger

would reduce competition in that market. As many frustrated bankers with the urge to merge have discovered the hard way, this policy tool has become a serious bar to bank acquisitions.

But what about banks that don't compete in the same market? Can the distant presence of one such bank affect the rates that another bank charges or the services that it offers? Do banks have an impact on one another that's not a matter of actual competition in the same market? Many economists think they do have such an impact. Their reasoning is that the threat of competition from institutions in other markets, and the fact that these institutions someday may compete directly, can make bankers alter their behavior. If these economists are right, then clearly there's a place for regulatory initiatives that go beyond the encouragement of intra-market competition.

At present, this subject is being discussed under the rubric 'potential competition'. But there appears to be some confusion about

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just what the expression 'potential competition' describes. If so, the first step in clearing it up will be to show how competition of the ordinary sort works in a single market. Then it should be easier to see what happens when an outside firm threatens to enter a market and what happens when it actually moves in.

#### COMPETITION, PRICES, AND PROFITS

Economists have been looking at the relation of competition to prices and profits for hundreds of years. Dissected, poked, and prodded from almost every conceivable angle, this relation is perhaps the most thoroughly studied item in the whole of economics. Theories have changed over time. But from the crudest eighteenth-century formulations on up to the most recent and sophisticated theorizings, the conclusion almost always has been the same: more competitors and competition in a given market show up in lower prices and (when applicable) better service. This conclusion has been confirmed by statistical studies of many industries, from the most obscure to the most visible. Not to be outdone by their counterparts in other industries, banking economists usually have come up with the same finding: competition makes a difference. For markets in general, this conclusion is about as well accepted as anything ever gets to be in the argumentative world of the economist. It's not surprising, therefore, that a great deal of antitrust legislation, much of it bearing on the banking industry, has been founded on this conclusion.

But when a banker thinks of competition, he may have tomorrow's in mind as well as today's. There's always a chance that a new bank will enter a given market, if permitted, especially if that market is unusually profitable. If the new bank moves in independently instead of merging with a local bank, the local bank may lose business or have to make a stronger effort to retain its customers by giving them more or better services or lower prices—which could reduce profits.

And bankers, like other businessmen, don't like to see their profitability drop.

Under these circumstances, the local banker has a choice: either make the market less attractive to outsiders now by charging less for services, or continue profitability at a higher level now and run the risk of having more competitors and lower profits in future.

**Limit Pricing: Response to a Threat.** The exercise of restraint in pricing, based on the fear that higher prices—and hence profits—would invite competitive firms into a market, goes under the name 'limit pricing'. In a limit-pricing situation, the threat of entry by outsiders influences the present conduct of firms in a market *even though no market entry occurs*. The outcome may be seen in lower rates for loans, higher interest on deposits, and lower service charges—all good things, from the customer's point of view.

The key assumptions here are two: that bankers who might invade a market (potential entrants) tend to base their decisions on the prices and profits of firms already operating in that market; and that local firms tend to respond to the potential entry threat with pricing policies designed to get the most out of profits over the long haul, despite the effect on short-term earnings. Are these assumptions borne out? Economists disagree. But it's clear that, if limit pricing does occur, it may be an important ally in the effort to keep prices at competitive levels.

Even better, it's an ally that comes to the rescue when it's needed most. If a banking market is highly competitive, prices already will be relatively low and the consumer will be relatively well served. There will be little reason to be concerned with an entry threat, since outside banks won't have the promise of unusually high prices or profits to lure them in. But where a dominant bank in a noncompetitive market is considering a price rise or a service reduction, the entry threat may be important, since it's likely that new firms will be attracted by the higher price structure. In this latter case, where market

competition is weak, limit pricing should be working to hold down prices and profits.

Thus the threat of entry posed by an outsider can be serious business. But this is not the only way that the outsider can affect prices and services in a market. The potential competitor also can decide to move in and start actually competing.

**After the Threat: Post-Entry Impact.** The bank that enters a new market by opening a branch on site may have some effect on prices and services. It's well known that more competitors in a market usually pre-empt lower prices or better services. So an outsider that's likely to add to the list of competitors by entering a new market can be useful to have around.

The notion that an outsider may improve competition in a market by actually entering it, rather than by simply threatening to enter it, is what economists have in mind when they speak of probable future competition.<sup>1</sup> While the influence of limit pricing is reflected in market conduct now, probable future competition is concerned with the prospect of an improved market structure—a better number and mix of market competitors—later on. Since the entry of new competitors is more important when competition is relatively weak, actual market entry too is likely to be of greater significance in markets that are less competitive.

Thus limit pricing and actual market entry in the future both may be sources of increased market efficiency. But knowing that efficiency may be promoted in these ways isn't enough for economists, regulators, and policymakers. They want to know when in fact these phenomena occur and how much of a difference they make.

<sup>1</sup>This term was introduced by Stephen A. Rhoades. For a further discussion, see his "Clarification of the Potential Competition Doctrine in Bank Merger Analysis," *Journal of Bank Research* 6 (1975), pp. 35-42.

## EVIDENCE FOR POTENTIAL COMPETITION

It's not easy for the observer to identify a case of limit pricing. As a result, evidence that it occurs at all has been woefully lacking. One way to pinpoint it in banking would be to measure the threat of entry faced by local banks and then to see whether banks that face greater entry threats tend to charge lower prices for their services. State branch banking laws often narrow the field of new entrants by indicating which banks are permitted to enter a given market and which are excluded. Using the state branching laws as a starting point, the Philadelphia Fed currently is conducting research to determine whether limit pricing is a factor in the way some banks operate. Identifying occurrences of limit pricing remains a pretty tough task, though, and evidence from many different studies employing different methods may be necessary before the question can be truly resolved.

The evidence for a new entrant's post-entry impact is much better than the evidence for limit pricing. It's not hard to observe that some banks enter new markets and that more banks in a market usually bring more competition and a better break for the consumer. In Pennsylvania, for example, more competition in local banking markets has been found to result in higher rates paid for savings deposits.<sup>2</sup> But for

<sup>2</sup>See, for example, C. Glassman, "Banking Markets in Pennsylvania," in *Changing Pennsylvania's Branching Laws: An Economic Analysis*, Technical Papers, Federal Reserve Bank of Philadelphia, 1973, pp. 19-41. Other studies that confirm the relation of competition to the prices banks charge include D. Jacobs, "Business Loan Costs and Bank Market Structure," National Bureau of Economic Research, 1971, and F. Edwards, "Concentration and Competition in Commercial Banking: A Statistical Study," Research Report No. 26, Federal Reserve Bank of Boston, 1964. For a study of market entry by banks see S. A. Rhoades and A. J. Yeats, "An Analysis of Entry and Expansion Practices in Bank Acquisition and Merger Cases," *Western Economic Journal* 10 (1972), pp. 337-345.

policy purposes it would help to know also just how likely it is that any given outside bank will enter a market and how consequential the effect is likely to be. What will be the result if a bank new to the market starts bidding for consumer funds and business? And what will be the result if an outside bank acquires or merges with a bank that's already in the market? These are questions of magnitude that policymakers try to consider when they recommend changes in the branch banking statutes and chartering practices or review applications for merger.

#### **NEW ENTRY: TO MERGE OR NOT TO MERGE**

If potential competition has procompetitive effects, then it ought to have a bearing on which mergers are allowed to take place. A neighboring bank weighing the pros and cons of invading a new market by setting up new branches may cause more competitive behavior now, because it is threatening to enter the market, and a more competitive market structure later on, if it makes good that threat. But these advantages may be lost if our potential entrant is allowed to merge with a bank already in the market. Such a merger could reduce the new-entry threat faced by banks pondering price increases in that market. And it could eliminate the opportunity to get an extra bank into the market at some future time, and thus the chance to generate more market competition. Either way, potential competition suggests an argument against certain mergers, and this fact has not been lost on the people who are charged with maintaining competition in banking (see **THE REGULATOR'S DECISION**).

It would be a mistake, of course, to presume that mergers of banks in different markets always are undesirable. In some cases, the infusion of capital and managerial efficiency can turn a weak market competitor into an aggressive one, offering a greater array of services, lower prices, and increased convenience to customers. A sizable benefit may accrue also in the case of a failing

bank, where an opportune merger with an outsider may save the local banking market from becoming even more concentrated. But against these potential benefits must be weighed the costs of losing potential competition. By eliminating the entry threat posed by the outsider, a merger of banks in different markets may reduce pressures that currently keep prices down. And to this must be added yet another cost if the outsider lost through merger in fact would have entered the market on its own and added to the market's future list of competitors. These are separate and distinct costs which, if known with accuracy, could be compared with whatever benefits might result from mergers to arrive at a correct decision in every case. The trick then is to consider the benefits and costs in each case and to weigh them against one another. And that is almost a definition of one of the aims of bank regulatory policy.

#### **REGULATING BANKS IN A POTENTIAL-COMPETITION ENVIRONMENT**

In their attempt to oversee the banking industry where potential competition may be important, regulators face two severe difficulties—lack of information and regulatory inconsistency.

The information gap is unavoidable. While it may be useful to know that the competitive impact of a given merger can be decomposed into several different forces, some beneficial and some not, the inability to assess the magnitudes of these forces makes regulatory decisions difficult. Measurement of entry threats is especially difficult, and very little evidence has been available to guide decisionmaking here. Predicting the results of bank mergers in different markets is such a slippery undertaking because, even where potential competition is well understood, very little is known about the impact that potential competition can have in terms of dollars and cents. By how much, for example, will prices and services in a market be affected if the threat of entry into that market is reduced because of a merger? Until this

## THE REGULATOR'S DECISION

Banks compete with one another for customers in certain geographic areas—local banking markets. In order to reach a decision about a proposed merger of two banks, regulators first must determine where the relevant banking markets are. This determination often is made by analyzing data on population, commuting patterns, bank locations, and other conditions, that may be useful in marking off the areas where banks compete. To see the situation that regulators must come to grips with once the boundaries of these markets have been determined, suppose that Market A contains Bank 1 and Bank 2, neighboring Market B contains Bank 3, and Bank 3 is applying for permission to merge with Bank 2.



If Bank 3 is allowed to merge with Bank 2, it will be lost as a potential entrant into Market A. If banks in Market A keep their prices down out of fear that Bank 3 might enter with a new branch, then the loss of Bank 3 as a potential entrant may mean higher prices and fewer happy customers in Market A. This is how limit pricing can affect the desirability of allowing a merger.

Also, suppose that there is a high probability that Bank 3 will enter Market A with a new branch if it is not allowed to merge with Bank 2. If the merger is not approved, customers in Market A may benefit at some future date from having three different banks compete in their market instead of the present two. This would be an application of the concept of probable future competition, and it too could be relevant to the regulator's decision.

Of course, it's often difficult to determine how important these considerations are in any given case, and against the cost that may result from losing Bank 3 as a potential entrant into Market A must be weighed the benefits that might result from the merger itself.

question is resolved, some incorrect decisions may be the unhappy result.

More avoidable, perhaps, is the variety in the treatment accorded potential competition cases by different government agencies. The often tortuous route from merger application to final approval or denial can involve the state banking authorities, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Justice Department, and dif-

ferent levels of the courts (see THE SUPREME COURT. . .). And concern has been voiced that not all of these branches of government march to the same economic drummer. In the words of one critic: "Differences in the relationship of economic theory to Federal regulatory policy, on the one hand, and to guidelines laid down by the courts, on the other, are evidenced by the eight successive failures of the Justice Department to win a banking organization mer-

ger case in the district court when invoking the potential competition doctrine."<sup>3</sup>

#### DOING THE BEST WITH WHAT'S AVAILABLE

The current state of knowledge may not be

<sup>3</sup>Gary G. Gilbert, "The Potential Competition Doctrine in Commercial Banking: Theory and Policy," in *Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, 1974, pp. 140-156.

sufficient to guarantee a correct decision in every case, but it does indicate some useful guidelines to follow in making better decisions about potential competition. While more knowledge about the dollars-and-cents impact of potential competition certainly would help in the comparison of benefits to costs, it still is useful to make some appraisal of where potential competition is likely to be important and hence where regulatory action is more likely to produce the greater benefit. It's known, for example, that

### THE SUPREME COURT AND POTENTIAL COMPETITION IN BANKING

Recent Supreme Court decisions involving potential competition in bank merger cases have addressed in detail some of the important underlying issues. The opinion handed down in the recent *Marine Bancorporation* case, for example, shows how the Court tends to view these issues.\*

This case stems from the attempted acquisition of the Washington Trust Bank (WTB) of Spokane by the National Bank of Commerce (NBC) of Seattle, a subsidiary of Marine Bancorporation, Inc. As is evidenced by its opinion in this case, the Court sharply distinguishes probable future competition from limit pricing and recognizes the conditions under which each may need to be considered.

In regard to probable future competition, the Court noted that before it was possible to determine that the antitrust laws had been violated, it had to be shown "(1) that in fact NBC has available feasible means of entering the Spokane market other than by acquiring WTB; and (2) that those means offer a substantial likelihood of ultimately producing deconcentration of that market [reducing the share of deposits held by the largest banks] or other significant procompetitive effects."† Because Washington state branching laws make it difficult for a bank to enter a new market other than by merger, the Court held that the conditions for probable future competition were not satisfied in this case. The question of Court action if these conditions are satisfied has yet to be resolved.

The applicability of the limit-pricing concept was examined and also rejected in this case. Since the regulatory barriers keep NBC from posing a serious threat of entry except by merger, the Court reasoned, it is unlikely that this bank would exert any meaningful procompetitive influence over Spokane banks by standing in the wings.

From recent decisions, then, it appears likely that the Court may consider potential competition where state laws don't restrict bank expansion. Whether it will consider potential competition in other circumstances is a question yet to be answered.

\* 418 U. S. 602 (1974).

† 418 U. S. 623.

the less competitive a market is, the greater is likely to be the benefit that results from potential competition. The threat of entry now or the prospect of entry later by an outside bank means little in a competitive market but may have a sizable influence in a non-competitive one. It seems likely also that the more ready, willing, and able a bank is to branch into a new market, the more credible is the entry threat it poses and the more likely is its actual entry in the future. Thus a large, well-managed bank with a history of branching activity is likely to have a bigger impact as a potential entrant than a small, un-aggressive one. Finally, the fewer the banks that are willing and able to enter a market, the more important it is when any one of these banks is lost through merger, if potential competition is a factor.

Together, these considerations indicate a policy that regulatory agencies often follow: take action against a proposed acquisition when the market in question is highly non-competitive and when the outsider is one of only a few banks that might enter with a new branch.

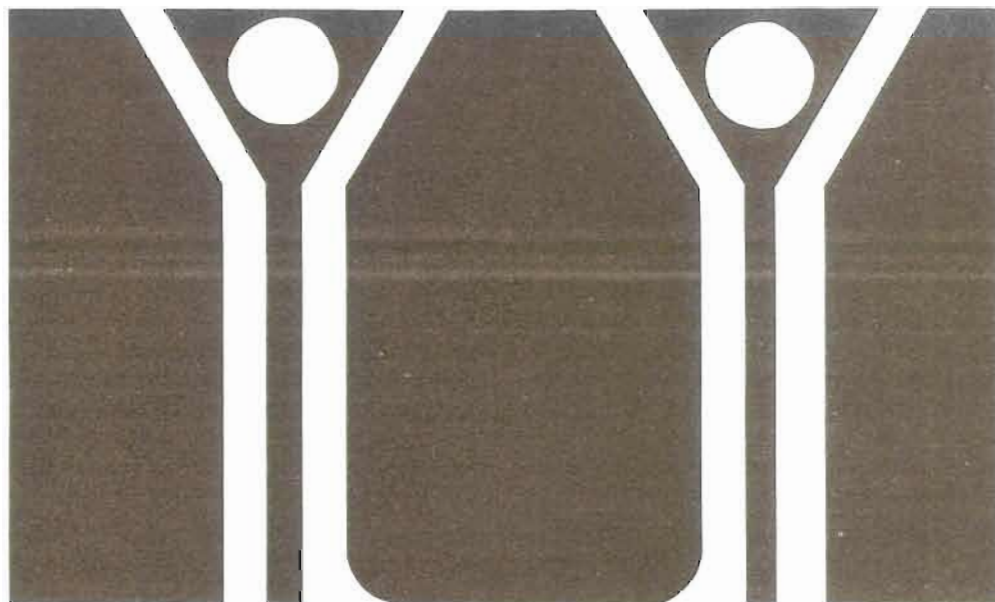
For now, a policy based on knowledge of when potential competition is likely to be important, bolstered by a fair amount of educated guessing, probably is the best that can be hoped for. Better information about the significance of potential competition in banking would make future decisionmaking

a little easier. But even in the present state of our knowledge, drawing the line somewhere in bank merger policy is likely to be better than not drawing it at all.

An altered bank merger policy is not the only vehicle by which more information about potential competition could change things for the customer. Potential competition is relevant also to decisions about branch banking restrictions and chartering procedures. The fact that legal restrictions on branch banking may reduce the threat of entry as well as actual entry into local banking markets surely must be considered in assessing the desirability of such restrictions. Similarly, information on the extent to which chartering requirements for new banks reduce the list of potential competitors someday may have a significant influence on decisions about such requirements. Then too there are the recent moves to make other financial institutions more closely competitive with commercial banks, such as the authorization of negotiable order of withdrawal (NOW) accounts for mutual savings banks. Changes in the number and mix of competitors may have an impact not only on regular competition within banking markets but also on potential competition. As we gain more information on potential competition, we may yet find it to be a valuable ally in keeping banking markets competitive and banking customers happy.

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