Testimony

of

William L. McQuillan

President

of the

Independent Bankers Association of America

before the

United States House of Representatives

Committee on the Judiciary

on
"The Effects of Consolidation on the State of Competition

in the Financial Services Industry"

June 3, 1998

William L. McQuillan
President
Independent Bankers Association of America
1 Thomas Circle, NW
Suite 400
Washington, DC 20005

(202) 659-8111

Good afternoon, Mr. Chairman, I am Bill McQuillan, president of the Independent Bankers Association of America and president of The City National Bank, an $18 million bank located in Greeley, Nebraska. I also serve as an elected director on the board of directors of the Federal Reserve Bank of Kansas City.(1) It is an honor and a pleasure to appear on behalf of the IBAA before the House Judiciary Committee, and to discuss the timely issue of bank mergers and their potential for anticompetitive effect. In particular, Mr. Chairman, the IBAA appreciates the opportunity to set forth on the record a brief summary of our concerns about recent bank mergers and the trends they reflect and augur. We appreciate that this Committee, under your leadership, is taking a hard look at the recent wave of mergers. Although banks and banking have not been a core concern of this Committee, we believe that a number of proposed bank mergers that currently await regulatory approval raise issues of concentration and competition that have long been central to this Committee's work. We appreciate that the Committee is deploying its considerable antitrust background and expertise to look into these developments.

I want to organize my remarks today in terms of two ostensibly separate types of bank mergers: those between existing banks, and those between banks and nonbank entities. Both are, of course, subject to section 7 of the Clayton Act.(2)

BANK-BANK MERGERS

The first of these--mergers between existing banks--falls easily into traditional patterns of antitrust analysis, generally that concerned with so-called "horizontal mergers." The assumption has been that such mergers between competitors present obvious dangers of restraining competition. On the other hand, at least two factors are relied on by the proponents of interbank mergers to dismiss those dangers. First, we are told, many recent and proposed bank mergers have principally affected markets in which competition is and will remain robust, thanks to a large number of competitors; consequently, the argument goes, the loss of a number of competitors to interbank mergers will have no appreciable anticompetitive effects, such as a diminution in accessibility and quality of banking services and an increase in fees.

Second, we will be told, many of the very largest interbank mergers, including that proposed between NationsBank and Bank of America, involve large banks that have not generally competed in the same geographic markets. In fact, we may be told that such transactions are not really horizontal mergers at all, but conglomerate mergers involving non-competing (albeit huge) entities in discrete markets. Consequently, the argument continues, the consolidation of behemoths, whose operations are concentrated on the east and west coasts respectively, can entail few legitimate fears of anticompetitive effect.

We believe this argument to be conveniently myopic. We must look behind such gross generalities advanced to excuse all manner of interbank mergers. For example, it is time to reexamine the relevance geography has to market definition in the modern banking industry.

Modern banking is no longer bound by local and isolated markets. We are dealing with a global, 24-hour market in currencies, securities and funds, linked by computers and, as a practical matter, accessible to all. Clearly credit card and debit card marketing and usage know no geographic boundaries. And large bank mergers impact the already limited ownership of the crucial electronic payment networks. Accordingly, the fact that each of two large merger candidates maintains brick-and-mortar retail banking outlets primarily in disparate geographical localities is irrelevant in terms of potential anticompetitive impact. The question is: What is the nationwide effect of truly nationwide banking?

Effect on Prices, Small Business Lending and Economies of Scale

We should examine empirically the economic impacts of recently-consummated interbank mergers. What have been their real effects, on access to banking services by consumers, and on convenience? What have been their observable effects on the level of fees and charges, and related phenomena such as minimum balance requirements? Have fees gone down and services expanded, as the proponents of these mergers would have us believe? Or, have fees to consumers gone up as large banks have become increasingly bureaucratized and oblivious to the needs of their customers?

In fact, the body of evidence shows that increased concentration has not benefitted bank customers, who correctly perceive an across-the-board increase in fees and charges. According to a March 1998 Checking Account Pricing Study of 350 banks nationwide conducted by Bank Rate Monitor, none of the top 50 banks in the U.S. offer the least expensive checking account. The best deals are offered by smaller regional and community banks. Ironically, the banks offering the most expensive checking accounts turned out to be none other than the banks involved in the latest round of proposed megamergers: Citibank, San Francisco; Barnett Bank, Tampa (merging into NationsBank); NationsBank, Tampa; and NationsBank, Orlando.

The Federal Reserve Board's Annual Report to the Congress on Retail Fees and Services of Depository Institutions (June 1997) found that the average fees charged by multistate banks are significantly higher than those charged by single-state banks, even accounting for the role of locational and other factors that might explain differences in the level of fees charged. And a 1997 study by the U.S. Public Interest Research Group, *Big Banks, Bigger Fees*, found a widening fee gap between large and small banks as fees climbed at big banks, while dropping at small ones. In the previous two years, fees at large banks had risen 3 percent, but fell 2 percent at small banks.

A recent paper by two economists (Simons and Stavins) at the Federal Reserve Bank of Boston questions whether antitrust enforcement has been sufficiently vigorous since mergers have an adverse effect on consumer deposit pricing. Their study of 499 bank mergers found the combined banks lowered interest rates paid on deposits regardless of the amount of competition in the market. In short, there is reason to believe that the vaunted "efficiencies" to be realized by interbank mergers are not in fact being passed along to the consumers. If not to consumers, then to whom?

The effect of interbank mergers on small business lending is also of concern, as small business lending receives short shrift in a banking world of ever larger entities. Generally, the percentage of small business lending is inversely proportional to bank size. According to another Federal Reserve Bank of Boston analysis (Peek and Rosengren), banks under $100 million involved in bank mergers on average had 16 to 19 percent of their loan portfolios in small business loans, while banks over $1 billion involved in bank mergers had on average 6 percent of their loan portfolios in small business loans. And interestingly, small bank acquirers tend to increase small business lending while large acquirers tend to reduce it. Peek and Rosengren note that several recent studies have found small business lending is also growing faster at small banks than large, and that large acquirers are less likely to expand in this sector. They found that banks with less than $100 million or more than $3 billion of assets each had asset growth of about 24 percent from June 1993 to June 1996, yet growth in small business lending (loans under $1 million) was 42 percent at the small banks but only 3 percent at the large banks.

Equally important, we question whether interbank mergers really present the opportunities of increased efficiency that their proponents claim. One recent study indicates that, except below a relatively low threshold in terms of combined assets, bank mergers do not in fact result in the realization of increased efficiency through economies of scale--a common economic rationale for horizontal mergers in any industry. Several other studies (including those conducted by the Harvard Business School and the Federal Reserve Bank of Atlanta) found no significant cost savings or profit improvement (measured as return on assets or gross operating income) as a result of mergers. Ironically, in the Harvard Business School study of New England bank mergers, instances of improved operating results (such as improvement in net interest margin) was due primarily to higher repricing rather than economies of scale, which strongly suggests the use of market power to raise prices, and again raises antitrust concerns. Given sufficient market power, large banks could price smaller competitors out of the market with below market rate loans or above market rate deposits.

We suspect that economies of scale may actually become negative once a merged banking entity exceeds some critical mass, because the increased costs of management and bureaucratization will at some point overwhelm any theoretical economies of scale. The evidence suggests that the optimal size for a bank in terms of economies of scale, profitability and efficiency is between $100 million and $1 billion. An analysis of the largest 100 banks in the May 1998 issue of *USBanker* shows that as a general rule the largest banks have poorer asset quality, lower profitability, less efficiency and weaker capitalization than the smaller banks on the list.

In sum, Mr. Chairman, the recent trends favoring consolidation in the banking industry are coupled with widely-held suspicions that (i) realized efficiencies are overstated or non-existent, and/or (ii) the benefits of such efficiencies as may be realized are not being shared with bank customers, and (iii) increased market power is used to raise prices. We believe that the historical expertise and focus of the Judiciary Committee should be engaged to illuminate these issues promptly.

Effect on ATM Network and Credit Card Markets

ATM Network Markets: A key concern in large interbank mergers, and one that does not get the attention it warrants, is the effect on ATM networks. Market concentrations resulting from bank mergers and acquisitions have potential anti-competitive implications for ATM network markets (specifically control of ATM switches).

ATM networks are joint ventures between competing banks. ATM networks are self-regulated, private sector entities, owned and controlled in the majority of cases by large banks, that set their own pricing and related operating rules subject only to the constraints imposed by the antitrust laws. Given the structure of ATM networks, certain anti-competitive aspects are inherent. For community banks, these anti-competitive aspects are more pronounced as they generally have little influence over network fees, bylaws or operating rules. Access at a fair price to ATM and other electronic financial services networks is critical for community banks to insure their customers also have fairly and competitively priced access to these networks to transact their banking business.

Big bank mergers affect ATM networks in two ways. First, ATM network mergers typically follow. For example, NationsBank and First Union acquisitions in the South prompted the merger of the Honor and Most ATM networks (NationsBank owns 30 percent, the largest single share, of the Honor network). NationsBank's purchase of Boatmen's Bancshares of Missouri prompted Honor's acquisition of the BankMate network in St. Louis formerly owned by MasterCard and three smaller networks. Currently, First Chicago owns 30 percent of the Cash Station network and 25 percent of Magic Line. Banc One owns 20 percent of Electronic Payment Systems, Inc. which operates the MAC network. The pending Bane One/First Chicago merger could result in mergers of all of these networks. (Interestingly, EPS/MAC entered into a consent decree with the Department of Justice in 1994 agreeing to cease certain anti-competitive practices that caused over 1,000 banks, particularly small banks, thrifts and credit unions, to pay higher, noncompetitive prices for ATM transaction processing.)

In the short term, the industry's merger mania is rapidly paving the way for an oligopolistic ATM network market owned by a handful of the nation's largest banks. Essentially, these banks control the pricing, policies and functionality of the nation's ATM networks. Given this control, large banks could limit access for community banks and their customers by imposing anti-competitive and discriminatory pricing, membership requirements, operating rules or technological barriers. Since network policies directly affect the ability of community banks and other small financial institutions to offer competitive ATM services for their customers, they must be allowed to participate fairly in the governance of ATM networks in order to protect these interests.

We note that under current law, the Federal Reserve has the authority to approve or veto ATM network mergers or mergers of other payments processing entities owned by banks. In the past, IBAA has urged the Federal Reserve to consider the electronic banking markets when determining whether a proposed bank merger/acquisition passes antitrust tests. We have urged the Federal Reserve to ensure that its competitive impact analysis evaluates: 1) the market power of a network brand, 2) fees, 3) routing rules, 4) third-party processing requirements, and 5) other factors that could be used to disadvantage community banks.

The second way big bank mergers can effect ATM networks is that, over the long term, large banks could transfer their transaction processing from regional ATM networks to their in-house operations. BankAmerica Corp. is currently the largest ATM owner, and its merger partner NationsBank is second. Together they control more than 15,000 machines--a number that is comparable to multibank shared networks such as Pulse or NYCE. The Banc One/First Chicago merger will result in the nation's second largest ATM owner with almost 10,000 machines. (By contrast, all community banks combined own fewer ATMs than NationsBank/Bank of America.) Excess capacity could be created in existing regional electronic networks as large banks pull transactions out of the network as a consequence of mergers. If this excess capacity is not shifted to smaller financial institutions, the consumer of electronic payment services will have less and less choice. And the customers of community banks, savings and loan associations and credit unions could be forced out of electronic commerce by pricing and other decisions of the fewer and fewer network owners.

Our concerns in this regard parallel those faced by the settlers of Nebraska and other Midwest states early in this century. A few railroads essentially controlled the rural economy. A few banks should not be allowed to control the electronic payment system "railroads" to the detriment of consumers of those payment services.

Credit Card Markets: We have a major anti-competitive concern in the credit card area. Large bank mergers could create an oligopoly of credit card issuers led by Citicorp, Banc One and NationsBank. Citibank is currently the largest issuer of credit cards with 65 million cards outstanding. Banc One/First Chicago combined will hold the number two spot with 53 million cards. NationsBank/Bank of America combined will have 24 million cards outstanding. Once the pending mergers are consummated, the top ten credit card issuers will control 72 percent of the credit card market, according to Robert McKinley of RAM Research in Frederick, Md.

Under today's rules of the game, by using the Visa or MasterCard umbrella, thousands of community banks are issuers of credit and debit cards and set their own pricing and terms. Thousands of community banks and their credit and debit card customers can tie into the Visa and MasterCard brands, which confers on the cards the national and worldwide acceptance essential for the cards' viability. Like ATM Networks, the two card associations, Visa and MasterCard are joint ventures and all competing member banks enjoy the strength of two brands that are recognized and accepted around the world.

We have already heard the ad "Don't think Visa, think Citibank Visa" (i.e., it's not just a Visa Card, it's a Citibank Visa Card). It is our concern that down the road the ad you hear from Citibank or Banc One will jettison the Visa or MasterCard brand name in favor of a credit card or debit product that they exclusively own and control. And with the destruction of the Visa or MasterCard brand names, combined with large banks' long-term goal to destroy the FDIC symbol now on every bank door, enormous financial concentration to their benefit and to the detriment of thousands of community financial institutions and their customers will have been achieved. And then the consumer will suffer because we will be back in the brave new world where every credit card issuer charges a $35 annual fee and a 19.6 percent interest rate regardless of market interest rate fluctuations. And the taxpayer will suffer when the inevitable occurs, and a large financial conglomerate Titanic goes down.

At best, the card brands will be systematically weakened to the detriment of smaller issuers forcing them out of the business because they will not have the marketing budgets to compensate. Historically, Visa and MasterCard have offered baseline marketing and enhancement packages that virtually any size member bank could take advantage of. Increasingly the large issuers will not be willing to support such product parity preferring instead to use their considerable influence to assure their own cards stand out. This in turn, will hinder cooperative brand advertising serving to obscure the message to consumers that other Visa and MasterCard offers are available, not just a "Citibank Visa."

Consumers will not only be disadvantaged by choice limits and higher pricing, some will find themselves "de-marketed" from the card product entirely. With increased consolidation and less competition, large issuers will begin to look for other ways to improve profits. For example, some issuers are already "de-marketing" by eliminating value-added enhancements, changing terms, assessing inactive fees and using other disincentives to discourage transactors, those consumers who pay off their balance each month to avoid finance charges. In addition to simply not offering the card product or raising annual fees, the grace period will be reduced or eliminated as the large card issuers focus on the more profitable revolvers, those who maintain a balance from month to month and pay finance charges, in a sort of reverse discrimination. In Canada today, where only a few large banks exist, most cards carry a high annual fee, $25 to $39, and reduced grace periods, from no grace period to just over 17 to 21 days (Office of Consumer Affairs of Industry Canada, Feb. 1998). Revolvers on the other hand will be held captive with higher annual percentage rates (APRs) applied using the highest possible compounded calculation methods and no grace periods along with higher late fees, over-limit fees and risk-based pricing.

Small merchants will also be affected. Already, the core interchange rates that form the basis for merchant pricing favor large merchants which are generally contracted with large banks. Just a few years ago, most of the large banks had bailed out of the merchant business leaving it fragmented and primarily in the hands of non-banks and small community banks. Now the big banks are back with a vengeance and have the clout to win market share. In today's electronic world and with linkages to other commercial services, it will become increasingly difficult for smaller players to compete. With large card bases, the mega banks can also offer special, targeted promotions that will further tie merchants and consumers forcing out the smaller players, primarily community banks. Once the competition is eliminated, merchants, especially small businesses, will have little choice but to pay whatever rates are charged.

CROSS INDUSTRY (BANK-NONBANK) MERGERS

The second type of bank merger involves the merger of a commercial bank and securities firm under a bank holding company format and the proposed, and we believe highly questionable and probably illegal, proposed takeover of Citicorp by Travelers Group, Inc. through a newly organized holding company called Citigroup. This application is pending before the Board of Governors of the Federal Reserve System and is intended to create an entity, Citigroup, with combined total assets of $697.5 billion.

As you know, Mr. Chairman, the House of Representatives after a three year struggle has just passed legislation, H.R.10, the purpose of which is to permit the common ownership of commercial banks, securities firms and insurance companies. It would be an enormous stretch of the Bank Holding Company Act for the Federal Reserve to give a go-ahead to this merger proposal without the enactment of H.R. 10. We share Chairman Leach's concern, as reported by Reuters on May 7, that "this is not a deal that is contemplated under current law."

In traditional Section 7 analysis, mergers such as the Travelers/Citicorp merger have been referred to as "conglomerate mergers." Some will argue, Mr. Chairman, that the current wave of cross-industry mergers are in substance akin to mergers of horseshoes and potato chips, and are therefore devoid of anticompetitive effect.

At least with respect to such extraordinarily huge and complex transactions, Mr. Chairman, we suggest that a relaxed antitrust posture vis-à-vis conglomerate mergers is inappropriate, for at least two reasons.

In the first place, such conglomerate mergers may in fact be a far cry from what have been called "pure" conglomerate mergers, defined as one in which no similar or related products are involved, and one which would present little opportunity for reciprocal dealing in derogation of competition.[(3)] To refer specifically to the proposed Travelers/Citicorp merger, one may reasonably ask whether the products involved are so disparate and whether reciprocal dealing is so remote a danger as proponents of these transactions would have one believe.

The proponents have stated their intention to foster "cross-marketing" or "cross-selling" between the merged banks and other lines of business and "bundling" of various financial products and services, including those that would be divested in the absence of passage of legislation; and that such cross-marketing would survive a required divestiture.

Such "cross-selling" or "bundling" will not be entirely benign. If the entity resulting from a proposed bank-non-bank merger is a dominant force in allegedly discrete markets such as, for example, customer banking, stock brokerage and both life and casualty insurance, it is not difficult to imagine "bundles" with alarming anticompetitive effects in the financial services industry. Why, for example, might an auto loan not be "bundled" with automobile insurance? Why might brokerage not be "bundled" with money market management and checking privileges, perhaps through a "bundling" arrangement that discounts fees to customers who purchase related financial services? Such bundling by the gargantuan end-product of a Travelers/Citibank merger, of course, could enable the combined entities to assert overwhelming market impact, and, indeed, control, to the detriment of the consumer and free competition. Such proposed "bundling" may be demonstrably anticompetitive, as we have seen recently in other industries with sound analogies to the banking industry. The "bundling" of personal computer operating systems and Internet browsers comes readily to mind.

Second, Mr. Chairman, and relatedly: cross financial industry mergers may not really be conglomerate mergers in the first place, let alone "pure" conglomerate mergers. I refer to the fact that a national market in financial products and services may be the relevant market for purposes of Section 7 analysis, not a congeries of dissimilar and separate submarkets. It is undoubtedly true that many of the so-called "products" proposed to be marketed by merged bank-nonbank entities are not traditional banking products, and may therefore have been presumed to exist in discrete markets. But, importantly, many of these products are in fact competitive, in that they are all alternative repositories of private assets. This would be true, for example, of (i) savings accounts, (ii) life insurance and (iii) a 401(k) plan. If a bank-nonbank merger results in a financial services Godzilla, active in all such segments of the market, we suspect it could have profound anticompetitive effects.

ANTITRUST ANALYSIS OF COMMUNITY BANK MERGERS

Mr. Chairman, I would also like to take the opportunity to briefly address another aspect of antitrust analysis as applied to bank mergers that concerns us--namely, community bank mergers--even though this topic is not being directly considered by the Committee today.

Ironically, as regulators consider and approve mergers of ever-larger banks that approach the deposit concentration limits of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, mergers of community banks in local markets are being prohibited on antitrust grounds. For example, in 1996, the Federal Reserve Board denied an application by BancSecurity Corp. of Iowa, which controlled $415 million of deposits (1.1 percent of total deposits in the state) to acquire Marshalltown Financial Corp., which controlled $103 million in deposits (less than 1 percent of total deposits in the state). The combined entity would have controlled 1.4 percent of the deposits in the state. And it would have had 13 other depository institution competitors in its local market.

Many other community banks are dissuaded from even applying to make local acquisitions because they are told up front by bank regulators that the deals will not be approved on antitrust grounds. Recently, we were apprised that a bank with $41 million in deposits will be prohibited from acquiring a bank with $15 million of deposits because of antitrust considerations. Yet the merger of two small community banks can often strengthen competition by creating a stronger competitor to a "small" local branch of a large out-of-area bank. The current rules have the perverse effect of encouraging community banks to merge with out-of-area large banks, rather than merge with each other to increase efficiencies and competitiveness. The consequence could be the loss of all community banks in a particular market and the loss of local focus so critical to the ability of communities to survive and thrive.

These results seem absurd and are a clear indication that the framework of antitrust analysis, particularly as applied to mergers of community banks, should be revisited. Specifically, in analyzing the competitive structure of a particular market:

i) All thrift deposits and credit union deposits should be accorded full weighting. Currently, thrift deposits are weighted at 50 percent and credit union deposits are not weighted at all.

Thrifts and credit unions are full equal competitors for deposits. In many rural communities, credit unions are often the biggest deposit competitor that community banks have. And today, thrifts and credit unions alike make commercial loans.

ii) Nonbank and out-of-market competition must be taken into account. This includes deposit-like services (e,g., money market mutual funds with checking features, Merrill Lynch cash management account), securities firms brokering deposits to out-of-market banks or thrifts, and nonbank small business and consumer lenders (e.g., finance companies, equipment lenders, mortgage companies). Internet banking also changes the local competitive landscape.

CONCLUSION

In conclusion, Mr. Chairman, the ultimate goal of antitrust policy is to serve the public good. We urge that the Committee view these proposed megamergers in that context as well, and we recommend that the Committee consider lessons to be drawn from developments in other countries. To take one example, Japan's banking industry is in grave crisis--a crisis brought on, according to many, by the very intra- and cross-industry combinations we see occurring in our own country. The German economic system has dominant universal banks (which it is trying to move away from) and has been wrestling with a less than vibrant economy and a very high unemployment rate. We do not believe that the problems of any economy can be divorced from the country's banking system,.

In general, we do not believe that the current wave of mergers, planned and proposed, affecting the banking and financial services industry has been examined thoroughly in terms of traditional antitrust theory, specifically that developed under Section 7 of the Clayton Act, and especially by this Committee. We urge you to undertake a more formalized study or investigation of the effects that bank and financial services consolidation has had on competition, and the availability and pricing of services. We suggest that this Committee involve itself with the Citicorp/Travelers merger application now pending before the Federal Reserve Board at the very time that historic legislation permitting such a merger is pending before the Congress. We further urge your attention both to the effect that interbank mergers have on ATM network and credit card competition and to the application of completely outdated antitrust guidelines to deny small bank mergers.

Finally, we do not understand why anyone would want to radically change our current banking system. It is the envy of the world, with good reason. It has fostered the most successful and dynamic economy in the world. We appreciate your consideration of the antitrust implications and uncharted waters of a financial services world characterized by huge conglomerates which are being created as the Japanese model on which they are based is discredited.

Thank you, Mr. Chairman.

1. I note for the record that I am not the recipient of any federal grant, contract or subcontract funding.

Additionally, neither City National Bank nor the IBAA is the recipient of any federal grant, contract or subcontract funding.

2. 15 U.S.C. Section 18. Section 7 prohibits mergers or combinations where "...the effect of such acquisition may be to substantially lessen competition, or to tend to create a monopoly." Section 7 applies to bank mergers. *United States v. Philadelphia National Bank*, 374 U.S. 321, 83 S.Ct. 1715, 10 LED 2d 915 (1963).

3. *See, e.g.*, 2 Von Kalinoski on Antitrust, Section 32.07[1] at 32-64 (1998).