Research on IO Topics in Banking: An Introduction and Overview

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I. Introduction

When Geoff Shepherd, the General Editor of this Review, asked the Board of Editors for ideas on a special issue, it occurred to me that the banking industry would probably be a good candidate. Of course, it is a very important industry that plays a major role in the savings-investment process and in the transmission of monetary policy. But banking is also a very large industry that includes as customers practically every household and business in the United States, and it is undergoing epic changes, including an unprecedented merger movement that is almost certain to continue for years. These changes and the characteristics of the banking industry make the industry an excellent laboratory for analyzing competition and strategic behavior, among other things. Indeed, during the past decade or so, there has been more IO-related research in banking than many students of IO might expect. However, because the industry is so large and ubiquitous, and such major changes are occurring in the industry, there are remarkable opportunities for additional research that would help to inform public policy and increase our understanding of competition and strategic behavior in real-world markets.

In soliciting papers for this issue, I asked for papers that examine a typical IO subject within the context of banking. I sent letters of solicitation to approximately two dozen economists located at universities or government agencies, who had a record of IO research in banking. All of the submitted papers and proposals were reviewed by three economists with an IO-banking background. Five proposals or draft papers were declined. The six papers that were accepted and appear in this issue were subject to two rounds of revision. I think the papers we have included, which analyze topics ranging from the influence of new entry and mergers on profit performance to the effect of consumer switching costs on prices, provide a good illustration of IO research that is being done in banking. All of the papers present applied research in that they are all empirical studies, all have policy implications to

* Federal Reserve Board, Stop 149, Washington, D.C. The views expressed herein are the author’s and do not necessarily reflect the views of the Board of Governors.
some degree, and they are based on theories and measures that, at least in banking, are practicable (that is, could be consistently and efficiently applied).¹

All of the studies search for evidence relating theory to the real world and analyze competition across markets within a single industry. At a minimum, the issues and methodologies are directly relevant to many other industries, and the findings may be relevant to firm behavior in general.

II. Background

A brief description of key features of the banking industry provides some perspective for those not familiar with the industry and suggests the wide range of issues attractive for study. The commercial banking industry is very large with about $4 trillion in assets, 1.5 million employees, and 10,000 banks. The industry has been very dynamic over the past fifteen years as illustrated by the chartering of approximately 3,200 new banks, 1,500 failures, 28,000 branch openings, 13,000 branch closings, and over 6,300 mergers between 1980 and 1994. Most notable among these dynamic features of the industry is a merger movement of unprecedented proportions that is restructuring the industry. The 6,300 mergers between 1980 and 1994 involved approximately $1.2 trillion in acquired assets. Since 1990 alone, there have been several mergers that were larger than any other mergers in U.S. banking history (BankAmerica-Security Pacific, Chemical Bank-Manufacturers Hanover, and NCNB-C&S/Sovran), and these were all surpassed in early 1996 with the merger of Chemical Bank and Chase Manhattan.

This merger movement in banking is likely to continue for years because a driving force behind the current bank merger movement, that is, the decade-long removal of legal restrictions on geographic expansion within and across states, was greatly reinforced when Congress passed the Branch Banking and Efficiency Act in September 1994. That law allowed interstate banking by bank holding companies in September 1995 and will allow interstate branch banking in June 1997. The move toward nationwide banking is barely underway and yet even in its early stages has had substantial effects on U.S. banking structure. Furthermore, the historic reduction of barriers to geographic expansion and the predictable wide-spread expansion of some very large firms, which has already begun, raise many interesting questions with regard to competition and strategic behavior in banking. For example, are the effects of entry (de novo and by merger) and potential entry as important as is now often assumed for antitrust purposes? In addition, the sheer presence (largely by merger) of exceptionally large, geographically diversified

¹ For those studies with implications for merger policy, the practicable attribute is especially important. There are hundreds of bank mergers every year, and the federal bank regulators, who are required to review every merger, have a very short time schedule for assessing the competitive and other effects of these mergers. Processing of even the largest mergers is expected to meet this time schedule. For example, the largest merger in U.S. banking history, the merger of Chemical Bank and Chase Manhattan into a $300 billion asset organization, was analyzed and approved by the Federal Reserve Board within the standard 60-day processing schedule.