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Chain Banks and Competition: The Effectiveness of Federal Reserve Policy Since 1977

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One-bank holding companies offer numerous financial and organizational advantages to bank owners. To achieve holding company status, however, the owners must satisfy Federal Reserve standards that involve financial, managerial, legal, and antitrust considerations. This paper examines the Federal Reserve's efforts to foster more competitive local banking markets through the application of a particular antitrust policy. It is concluded that the Federal Reserve's efforts have been largely successful.

The one-bank holding company has been a popular form of bank ownership for the past 15 years. From 1970 through 1985 nearly 7,000 applications to form such companies were filed with the Federal Reserve System. Approximately 98 percent of these applications have been approved. Those few applications, however, which were denied by the Federal Reserve were most often disapproved for financial, managerial, or legal reasons. In a small number of cases since 1977, however, disapproval has stemmed from competitive factors.

These competition-related cases were disapproved as part of what has been referred to as the Board's "chain bank" policy. Chain banking is a form of bank ownership in which control of at least two banks is vested in a single individual or a group of individuals. Occurring for the first time in the late nineteenth century, chain banking was a response to the restrictive branching laws of certain northwestern and southern agricultural states. Unable to establish branches throughout counties or across county lines, bankers who sought to expand the geographic scope of their operations simply acquired banks in different locations. Because these acquisitions were made by individuals rather than corporations, they were largely immune to formal antitrust review until the passage of the Change in Bank Control Act of 1978. As a result, many bankers acquired more than one bank within individual banking markets and frequently induced important anticompetitive effects.

The Federal Reserve Board began to examine the antitrust implications of some chain banking ownership patterns when owners of chain banks sought to place their banks into one-bank holding companies during the 1970s. The Board's analysis of these formations has typically been conducted in two stages. The first is an assessment of any competitive effects that could arise from placing the target bank into a one-bank holding company (this portion of the competitive assessment has almost always been a pro forma matter since the formation usually is merely a corporate reorganization). The second phase of the analysis consists of examining the competitive effects of any affiliation that the target bank may have formed with other banks in the same geographic banking market in the past. For example, assume that bank A, which has been in operation more than five years, applied to form a one-bank holding company in year t. Assume further

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that bank A's owner had in some earlier year, say t-5, acquired bank B — a bank located in the same geographic market. Since bank A and bank B had been competitors before the acquisition, common ownership in year t-5 would have eliminated the competition that had existed. If this anticompetitive effect is judged to have been substantially adverse with no outweighing benefits of fulfillment of community convenience and needs, the Board would normally deny the holding company application in year t even though this corporate reorganization generated no further anticompetitive effects.

The Board's rationale for denying such cases is twofold and is clearly stated in a number of Board orders. One, the chain bank policy is intended to prevent the use of the holding company mechanism to further what already is an anticompetitive arrangement. Two, it is believed that denying such applications will encourage the eventual disaffiliation of the chain banks and thereby promote a more competitive market structure.

The study in this article examines the Board's chain bank policy as it has been implemented since the first chain bank case was denied in 1977. Such an investigation is of interest despite the small number of cases involved because it provides an avenue for investigating the effectiveness of a specific policy in an area in which the Federal Reserve has a regulatory responsibility.

Part one of the study examines the level of bank holding company formation activity during recent years and discusses some of the advantages and disadvantages of this type of bank ownership. Part two defines the chain bank issue as delineated by the Board and presents an analysis of those cases that have been denied under this policy. Part three presents evidence with respect to the incidence of subsequent chain bank divestitures and thus "tests" the effectiveness of the Board's policy.

An important conclusion developed in part three of this study is that the advantages of the holding company — especially certain tax advantages — provide a strong incentive to form such companies. This conclusion is supported by evidence that demonstrates that bank owners are willing to go to considerable lengths to achieve holding company status for their banks. Some observations on the Board's more recent implementation of the chain bank policy are also presented. The final section summarizes the study.

I. One-Bank Holding Companies: Advantages and Disadvantages

The popularity of the bank holding company (BHC) as a form of bank ownership has increased steadily since 1970. Table 1 demonstrates that the number of approved formations has increased in each of most of the years between 1970 and 1985, with formation activity reaching a peak in 1982. Overall, from 1970 through 1985, the number of BHC formation applications filed with the Federal Reserve System amounted to 6,899.[1]

The large number of BHC applications suggests that the advantages of the BHC form of bank ownership outweigh any disadvantages. These advantages, moreover, are broad-based and relate to an organization's ability to engage in nonbanking activities, its ability to expand geographically, the degree of control it can exercise over its own corporate ownership, and the firm's financial flexibility.

Since 1970, when amendments to the Bank Holding Company Act of 1956 were enacted, BHCs have engaged in a growing number of nonbanking activities. These include, but are not limited to, such activities as mortgage banking, consumer finance, leasing, data processing, courier services, certain management consulting activities, and merchant of futures commissions. BHC entry into many of these product markets has been extensive and has afforded many BHCs an important opportunity for diversification.

BHCs can also provide a convenient vehicle for geographic expansion in states that have restrictive branching laws. States that permit BHC expansion generally allow BHC acquisitions on an unrestricted, statewide basis. Thus, BHC acquisitions can produce nearly the same degree of geographic diversity as branching operations while preserving a high degree of local autonomy (through the retention of local officers and directors in the acquired bank).

Another advantage of the BHC form of bank ownership is the ability to exercise considerable control over corporate ownership. For example, the formation of a BHC provides the majority owners of the proposed bank subsidiary with an opportunity to eliminate minority shareholders within the bank and thus consolidate their control of the banking organization. This can be accomplished by forcing minority shareholders to accept cash (rather than shares of the forming BHC) for their bank shares. Certain regulations also give BHCs more flexibility than banks in incorporating anti-takeover measures into their corporate structure. BHCs, for example, have the ability to repurchase their own stock.

The BHC form of bank ownership also provides important financial flexibility. This flexibility derives from several sources. BHCs, for example, may enjoy an advantage in raising new capital and in structuring existing capital. Under present Federal Reserve standards, rules for including certain items as capital (such as equity commitment notes and intangible assets) are more liberal for BHCs than they are for banks. Also, certain BHCs (generally those with less than $150 million of assets) can engage in "double leveraging," in which funds borrowed by the parent company (debt) are "pushed down" to the subsidiary bank as equity capital.

Another very important financial benefit associated with the BHC form relates to the tax treatment of certain income and expenses.[2] One area in which these considerations are particularly important is the retirement of bank acquisition debt. Typically, personal debt is employed when an individual purchases a bank. The bank's owner usually retires this debt with bank dividend payments that accrue to him as owner of the bank. Dividend payments to the owner, however, are taxable as ordinary income. Thus, some portion of the dividend payments to the owner are "lost" to taxes and cannot be fully applied to debt retirement. All other things being equal, the amount of bank dividends that must be paid to service the acquisition debt will be greater in the case of individual ownership — in which "after-tax" dollars are being used to retire debt — than if all bank dividends went directly to debt retirement.

The creation of a one-bank holding company, however, enables all bank dividends to go toward debt retirement and thus effectively reduces the amount of dividend payments a bank must make in order to retire a given amount of acquisition debt.

TABLE 1

Bank Holding Company Formation Applications, 1970 - 1985

Year	Number of Applications	Number of Approvals	Number of Denials
1985	655	648	7
1984	963	959	4
1983	998	992	6
1982	1,089	1,086	3
1981	840	827	13
1980	690	681	9
1979	372	369	3
1978	273	259	14
1977	186	170	16
1976	155	143	12
1975	156	141	15
1974	154	138	16
1973	147	146	1
1972	123	112	11
1971	67	65	2
1970	31	31	0
Total	6,899	6,767	132

Source: *Federal Reserve Bulletin* for years indicated. Figures include both one-bank and multibank formations.

Typically, when the newly formed holding company "buys" the owner's bank, the BHC also agrees to assume the owner's acquisition debt as part of the purchase price of the bank. The source of funds to retire this debt remains, as in the case of the individual owner, bank dividends. A critical difference now, however, is that bank dividend payments to the BHC are (by IRS regulations) tax-free income to the BHC. Thus, the BHC can use the entire stream of bank dividends to retire acquisition debt. That is, no bank dividend payments are "lost" to tax payments.

The amount of bank dividends that must be paid in order to retire a given amount of debt, therefore, is less when the debt is retired by a BHC than when it is retired by an individual. Because the holding company can retire the acquisition debt with essentially tax-free dollars, the debt servicing burden on the bank is significantly less than if an individual retired debt with dollars on which he must pay income taxes.

A second important tax advantage of the BHC form is related to the ability of a BHC to file a consolidated tax return (combined parent company and bank subsidiary), and is known as the "tax-expense" benefit. Typically, bank subsidiary dividend payments to the parent company BHC (for small, undiversified holding companies) comprise the sole source of income to the parent holding company. These dividend payments, as noted earlier, are tax-free income to the parent holding company. Thus, the parent company has actual cash income but no taxable income (that is, it has a taxable income base of zero). The parent holding company, however, usually has tax-deductible expenses in the form of interest payments on acquisition debt assumed upon the purchase of its subsidiary bank. This combination of zero taxable income but positive deductible interest expenses generates a negative income tax liability for many small parent companies.

Without positive taxable income, however, the parent company cannot take advantage of its negative tax liability. By filing a consolidated tax return with a subsidiary bank that has a positive income tax liability, the parent company can effectively reduce the income tax liability of the overall organization by an amount equal to the subsidiary bank's marginal tax rate times the parent company's interest expense.

Typically, the subsidiary bank pays the parent company the value of this benefit. In the end, however, the subsidiary bank will not have incurred any greater total cash outlay than if the bank were owned individually. However, the holding company has additional cash which it may use to retire debt.

Compared to these substantial advantages, the disadvantages of the BHC form of bank ownership seem minor. Among the disadvantages are start-up and organizational costs which entail professional fees, franchise taxes, and staffing costs. In addition, the regulatory process itself imposes some costs upon the principals of proposed BHCs in the form of reporting requirements and greater regulatory scrutiny. These disadvantages notwithstanding, it is clear from Table 1 that the BHC is a form of bank ownership that many bank owners have chosen to adopt.

II. The Chain Bank Issue

The formation of a BHC requires the prior approval of the Federal Reserve System pursuant to Section 3(a)(1) of the Bank Holding Company Act.[3] Table 1 shows that all but 132 (two percent) of the 6,899 applications filed from 1970 through 1985 were approved. An examination of the formations that were denied reveals that most were disapproved for financial, managerial, or legal reasons. Twelve of the proposed formations, however, were denied for competitive reasons as part of the Board's "chain bank" policy, discussed earlier. (See Table 2).[4]

To reiterate, the Board's rationale for scrutinizing the competitive effects of one-bank holding company formations among commonly owned banks is that the BHC vehicle should not be used to further an anticompetitive arrangement, and that denial of such cases might lead to a procompetitive restructuring of the affected banking markets by precipitating a dissolution of common ownership. This rationale was clearly stated in the *Mahaska* decision, the first of the chain bank denials:

Section 3(c) of the Bank Holding Company Act requires the Board to consider whether any proposed acquisition by a bank holding company (1) would further the monopolization or attempted monopolization of a banking market, or (2) may substantially lessen competition or tend to create a monopoly in any banking market. Where, as here, a proposed acquisition involves the use of a holding company by a group of individuals to acquire control of a bank that is a competitor of another bank under the control of essentially the same individuals, the Board believes it must apply these standards. In the Board's view, the subject proposal presents a compelling case where the holding company is being used to further an anticompetitive arrangement.

While denial of the proposal may not immediately result in a complete termination of the present situation . . . it would preserve the distinct possibility that [the target bank] could again become an independent organization in the future. Approval, on the other hand would almost certainly foreclose that possibility since, as a result of the flexibility afforded by the holding company structure, Applicant would appear capable of servicing its acquisition debt, and, in addition, a mutuality of interest between the affiliate and [the target bank] would likely be established.[5]

When implemented in 1977, this method of analyzing the competitive effects of one-bank holding company formations clearly constituted a new approach to the Board's scrutiny of one-bank hold-

TABLE 2

Chain Banking Applications Denied by the Federal Reserve for Competitive Effects, 1977-1981

	Applicant	Bank to be Acquired	Date of Denial
1.	Mahaska Investment Co. (Oskaloosa, Iowa)	Farmers Savings Bank (Fremont, Iowa)	May 11, 1977
2.	Citizens Bancorp Inc. (Hartford City, Indiana)	Citizens Bancorp, Inc. (Hartford City, Indiana)	November, 18, 1977
3.	Midwest Bancorp (Gardner, Illinois)	Exchange Bank (Gardner, Illinois)	March 27, 1978
4.	Eicher Bancorporation (Iowa City, Iowa)	Hawkeye State Bank (Iowa City, Iowa)	April 25, 1978
5.	Mid-Nebraska Bancshares, Inc. (Ord, Nebraska)	Nebraska State Bank (Ord, Nebraska)	June 16, 1978
6.	First State Bancorporation (Fredericksburg, Iowa)	First State Bank (Fredericksburg, Iowa)	February 16, 1979
7.	Caneyville Bancshares Inc. (Caneyville, Kentucky)	Bank of Caneyville (Caneyville, Kentucky)	August 13, 1979
8.	Childress Bancshares, Inc. (Childress, Texas)	First State Bank in Childress (Childress, Texas)	January 28, 1980
9.	Lake Jackson Bancshares (Lake Jackson, Texas)	Lake Jackson Bank of Lake Jackson (Lake Jackson, Texas)	February 1, 1980
10.	Welch Bancshares, Inc. (Welch, Oklahoma)	Welch State Bank (Welch, Oklahoma)	August 19, 1980
11.	Semo Bancshares Corporation (Malden, Missouri)	Malden State Bank (Malden, Missouri)	May 12, 1980
12.	First Southeast Banking Corp. (Darien, Wisconsin)	First Bank Southeast of West Kenosha and First Bank Southeast of Twin Lakes (West Kenosha and Twin Lakes, Wisconsin)	March 6, 1981

ing company formations.[6] It was not clear, however, that the Board's approach to these cases would be beyond legal challenge, particularly in view of a related legal decision rendered in 1977. In that decision the Board's denial of a one-bank holding company formation on the basis of financial factors (*First Lincolnwood*) was overturned in district court on the argument that ". . . in order to be grounds for disapproval, the condition or tendency deemed not to be in the public interest must be caused or enhanced by the proposed transaction."[7]

In a second competitive chain bank denial which quickly followed *Mahaska,* however, the Board argued that the *First Lincolnwood* decision did not apply because (1) *First Lincolnwood* related to aspects other than competitive factors; (2) consummation of the current holding company formation proposal is related to competitive (not financial) factors and *would* enhance and further an anticompetitive arrangement; and (3) evasion of the Bank Holding Company Act would be facilitated and encouraged.

Any uncertainty regarding whether chain bank cases could be legally denied did not exist for long. In 1978, the U.S. Supreme Court upheld the Board's authority to deny one-bank holding company formations even though the formations did not exacerbate pre-existing financial factors.[8] This 1978 decision clearly established the Board's authority to deny one-bank formations for adverse financial and managerial factors. It was also seen as confirmation of the Board's authority to deny formations on the basis of competitive factors as well. Any remaining doubt on this point was removed in 1980 when the only legal challenge to a Board competitive chain bank denial was rejected in court.[9]

Characteristics of Chain Bank Denials

From 1977 to 1981, the Board denied twelve proposed formations for reasons relating to the competitive effects of past affiliations. These twelve cases, listed in Table 2, are examined more closely below to review the competitive factors in question. Some of the data relating to the cases are presented in Table 3.

TABLE 3
Market Characteristics of Chain Bank Denials[1]

Case	Geographic Market	Deposit Size of Market ($ million)	Deposit Size of Bank ($ million)	Number of Banking Competitors	Concentration: Four-Firm Ratio (percent)	Concentration: HHI[3]
1. Mahaska	Mahaska County	92.4	12.4	5	92.8	3028
2. Citizens	Hartford City	76.8	27.5	4	100.0	3302
3. Midwest	Grundy County	180.6	8.6	6	87.8	2494
4. Eicher	Iowa City	281.8	17.4	9	78.2	2046
5. Mid-Nebraska	Valley County	46.4	14.7	5	90.8	2600
6. First State	Chickasaw County	88.2	10.9	6	78.6	1953
7. Caneyville	Grayson County	70.4	7.1	4	100.0	2805
8. Childress	Childress County	20.5	13.7	2	100.0	5558
9. Lake Jackson	Brazoria County	318.6	36.2	13	67.6	1310
10. Welch	Ottawa County	180.0	9.1	10	82.0	2786
11. Semo	Malden County	77.4	29.8	6	83.5	2331
12. First Southeast[2]	Kenosha County	292.1	11.1 9.0	8	87.4	2407

[1]Data are as of time of application.

[2]This application involved an existing one-bank holding company that applied to acquire five commonly owned banks. Three applications were approved; two were denied. For purposes of this study, the two denials are discussed as if they were a single chain case.

[3]The HHI is obtained by summing the squared market share of deposits of each banking organization. The Department of Justice presently considers an index of 1800 or higher to comprise a high degree of concentration.

Several important observations can be made from this information. First, virtually all of the target banks involved in the twelve denials were small banks located in small, primarily rural banking markets. The smallest of the target banks (*Caneyville*) had deposits of only $7.1 million at the time of application. Even the largest (*Lake Jackson*) had only $36.2 million of deposits. For the entire group of twelve banking organizations, the average bank size amounted to $16.0 million.

The markets in which these banks operated were likewise small and contained few banking competitors. Five of the cases, for example, involved markets with five or fewer banking organizations. Six other markets had between six and ten banking organizations, and only one application involved a market with more than ten banking organizations. Similarly, the total deposits of the twelve markets averaged only $144 million.

The markets in which these twelve organizations operated also were, in all but one case, highly concentrated at the time of application. Eleven of the twelve markets had four-firm concentration ratios higher than 75 percent and a Herfindahl-Hirschmann Index in excess of 1800.[10] Only one case (*Lake Jackson*) involved a market of moderate concentration.

The profile, then, that emerges of the banks and markets in these cases is one of small banks operating in small, highly concentrated markets. Within such markets, it is not difficult to imagine that past multiple acquisitions of banks could have resulted in significant anticompetitive effects.

An Analysis of the Denials

Data related to the anticompetitive effects of the twelve denials are presented in Table 4. Among the most obvious and most important aspects of these cases is that the target bank and its affiliate(s) accounted for a relatively large market share of deposits at the time the common ownership of shares (anticompetitive affiliation) occurred. Eleven of the twelve applications, for example, involved affiliations in which the combined market share was greater than 24 percent. Only one proposal (*Eicher*) involved a market share combination of lesser mag-

TABLE 4

Deposit Size and Market Shares of Banks Upon Occurrence of Common Ownership

Case	Deposit Size and Market Share of Target Bank ($ millions)	Deposit Size and Market Share of Target Bank (% Total Deposits)	Deposit Size and Market Share of Target Bank's Affiliate(s) ($ millions)	Deposit Size and Market Share of Target Bank's Affiliate(s) (% Total Deposits)	Combined Market Share (% Total Deposits)
1. Mahaska	12.8	14.2	42.8	47.4	61.6
2. Citizens	18.1	34.7	8.4	16.2	50.9
3. Midwest[1]	7.1	4.4	44.1	27.8	36.8
			7.3	4.6	
4. Eicher	18.2	6.1	20.6	6.9	13.0
5. Mid-Nebraska	6.4	26.7	3.1	12.7	39.4
6. First State	5.2	14.2	10.9	30.0	44.2
7. Caneyville	6.7	10.0	18.9	28.2	38.2
8. Childress	13.7	66.7	6.8	33.3	100.0
9. Lake Jackson	26.9	12.7	27.4	13.0	25.7
10. Welch	0.9	4.2	5.8	28.0	32.2
11. Semo[1]	6.7	35.2	2.5	13.0	59.5
			2.2	11.3	
12. First Southeast[1]	3.6	1.7	27.6	17.3	24.8
	7.5	2.6	5.1	3.2	

[1]Each of these cases involved a target bank that had two or more affiliated banks within the same geographic market.

nitude. Denial of this application resulted from unfavorable financial as well as competitive factors. The average combined market share for all twelve applications was 44 percent, ranging from a low of 13.0 percent (*Eicher*) to a high of 100 percent (*Childress*).

Eight of the twelve proposals involved affiliations of four years or less (Table 5). In two cases (*Welch* and *Semo*), however, common ownership had been in effect for more than 20 years prior to the application to form a BHC.

The duration of the anticompetitive affiliations in these cases was of considerable interest to the Board. In particular, it was believed by some Board members that there was little likelihood of disaffiliation in those cases where the period of common ownership was lengthy. Thus, it was argued, denial would have little chance of precipitating a subsequent procompetitive divestiture. Chairman Paul Volcker and Governor Lyle Gramley voiced this concern in the *Welch* application:

> We do not believe that denial of this application at this time will increase the probability that common control of the two banks will be terminated. The combined market share of the two banks is certainly substantial, and we would join the majority of the Board if there was some reasonable possibility that denial might result in severance of this relationship.
>
> The duration of this relationship is significantly longer than in any application previously denied by the Board solely on competitive grounds, however, and thus it appears unlikely that denial would have any meaningful effect.

Similarly, Governor Lyle Gramley stated in the *First Southeast* proposal:

> The affiliation between Kenosha, West Kenosha, and Silver Lake Banks has spanned nearly a decade. Denial in any of these cases would not increase significantly the probability that common control of the three banks will be terminated . . . so that the prospects for disaffiliation seem small.

The issue of the likelihood of divestiture in these applications raises the question of whether the Board's chain bank policy in general has been effective in promoting subsequent divestitures. Also, how soon following denial did the divestitures, if any, take place; and was divestiture related to the length of the affiliation? Answers to these questions are presented in the next section. They provide some evidence as to the overall effectiveness of the Board's chain bank policy.

TABLE 5

Duration of Anticompetitive Affiliation of Chain Bank Cases

Case	Year in which Common Ownership Occurred	Year in which BHC Application was Filed	Duration of Anticompetitive Affiliation
1. Mahaska	1976	1977	1
2. Citizens	1973	1977	4
3. Midwest	1976	1978	2
4. Eicher	1977	1978	1
5. Mid-Nebraska	1972	1978	6
6. First State	1972	1979	7
7. Caneyville	1978	1979	1
8. Childress[1]	1979	1980	1
9. Lake Jackson	1976	1980	4
10. Welch	1956	1980	24
11. Semo[2]	pre- 1960	1980	more than 20
12. First Southeast	1972	1981	9
	1977	1981	4

[1]This affiliation occurred two days prior to the effective date of the change in Bank Control Act of 1978.

[2]The exact date of affiliation in this case is unknown. However, Federal Reserve records indicate that common ownership among the three affiliated banks in this proposal began to develop as early as 1939.

III. Divestitures

For evidence on the incidence of divestitures, this study examined Federal Reserve records and interviewed individuals associated with the twelve denied applications. The results of these inquiries are presented in Table 6. The data reveal that divestitures subsequently occurred in eleven of the twelve denied cases. The only application in which no divestiture was recorded was *First Southeast,* and, in that instance, the commonly owned banks later merged. In several instances (for example, *Citizens, Mahaska,* and *Mid-Nebraska*), subsequent applications by the resulting nonaffiliated banks to form BHCs were refiled and approved by the Board following divestiture.

relatively short time after denial. In three of the twelve cases (*Citizens, Caneyville,* and *Childress*), a divestiture was made within six months or less. In four others (*Eicher, First State, Lake Jackson,* and *Welch*), the time to divestiture was less than 24 months. In only four applications (*Midwest, Mid-Nebraska, Mahaska,* and *Semo*) was the divestiture period significantly longer (45 months to 60 months). The average time from denial to divestiture was 27 months, or just over 2 years.

It is not possible to account fully for the motivations behind the divestitures that occurred. A bank owner's willingness to sell a bank depends upon any number of factors including the terms of purchase, availability of purchasers, and the presence of regulatory barriers. However, the most likely explanation for such a broadly based result — a 92 percent rate of divestiture (11 of 12) — is that the lack of holding company status prevented the owners of these banks from realizing the important benefits of BHC status discussed earlier.

In particular, a lack of BHC status would have prevented the realization of important debt-servicing tax benefits — a fact of some importance given that, in all cases that were denied, the proposed purchase of the bank involved the immediate or planned assumption of debt.[11] Since the Board's denial prevented the parties from realizing tax benefits, the principals of the banks appear to have decided that continued common ownership of the affiliated banks was a less favorable proposition than BHC status.

Recent Board Policy on Chain Cases

Since the *First Southeast* case in 1981, the Board has not denied a chain bank case. There are several possible explanations for this absence of denials. One is that banking antitrust standards have eased as the result of important banking legislation. Specifically, both the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 have

TABLE 6

Elapsed Time to Divestiture Following Denial

Case	Date of Denial	Did Divestiture Occur?	Month of Divestiture	Elapsed Time To Divestiture (Months)
1. Mahaska	May 1977	Yes	January 1981	45
2. Citizens	November 1977	Yes	January 1978	3
3. Midwest	March 1978	Yes	March 1983	60
4. Eicher	April 1978	Yes	September 1979	18
5. Mid-Nebraska	June 1978	Yes	March 1982	45
6. First State	February 1979	Yes	December 1980	22
7. Caneyville	August 1979	Yes	January 1980	6
8. Childress	January 1980	Yes	June 1980	6
9. Lake Jackson	February 1980	Yes	December 1981	23
10. Welch	August 1980	Yes	February 1981	19
11. Semo	May 1980	Yes	March 1984	46
12. First Southeast	March 1981	No	N.A.	N.A.

strengthened the argument that thrift institutions should be regarded as partial or full competitors of commercial banks. Counting thrift institutions as competitors increases the total number of "banking" competitors and thereby lowers concentration within markets. Thus, the competitive effects of any horizontal affiliation are likely to be less severe.

Two other developments have also served to limit denials under the Board's chain bank policy in recent years. The first arose in a 1983 chain bank application involving an affiliation of more than 40 years. In that case, the Board suggested that bank affiliations established before the passage of the Bank Merger Act of 1960 might appropriately be exempted from antitrust review.[12] Reviewing the effects of affiliations established before that year, it was argued, would unfairly apply antitrust standards that were created subsequent to the affiliation. This proposition was reiterated and expanded somewhat in a second approval decision made by the Board in 1983:

> The duration of the affiliation here is 24 years and did not represent an attempt to evade the antitrust laws or the BHC Act. Common control was effected in 1959, before the Celler-Kefauver Antimerger Act of 1950 was believed to apply to bank mergers; before the enactment of the Bank Merger Act of 1960, which required regulatory agencies to take competitive factors into account in approving mergers; and before the enactment of the Bank Merger Act of 1966, which clarified the applicability of the antitrust laws to bank mergers.[13]

A final contribution to the approval of chain bank cases in recent years has been the Change in Bank Control Act of 1978. This law, which embodies a competitive standard equivalent to that of the BHC Act, requires that changes in the effective ownership or control of a bank receive prior approval from one of the three federal bank regulatory agencies. Thus, seriously anticompetitive affiliations of the type which raise a chain bank issue presumably have not occurred since the passage of this law. As a result, the pool of potential chain bank cases has shrunk since 1978.[14]

IV. Summary and Conclusion

Beginning in 1977, the Board forged a rather well-defined policy with respect to the formation of bank holding companies from chain banks. This policy requires an assessment of the competitive effects of any prior affiliations between the target bank and other banks located in the same banking market. If the original affiliation had substantially adverse effects on competition within the relevant geographic market, the Board will normally deny the formation application based upon the requirements of the Bank Holding Company Act. The Board's purpose in applying the standards of the Bank Holding Company Act to these chain bank cases is twofold: to prevent the use of the holding company vehicle to further an anticompetitive arrangement and to promote conditions under which the anticompetitive chain affiliation might be dissolved in the future.

From 1977 to 1981, the Board denied 12 chain bank applications. The target banks involved in these applications were nearly all small institutions located in rural, concentrated markets. An examination of these 12 cases revealed that the Board's chain bank policy was highly effective. Procompetitive divestitures occurred in eleven of the twelve cases.

The Board has not denied any chain bank cases since 1981 for several reasons, including a general easing of banking antitrust standards, a determination that pre-1960 affiliations should be exempted from antitrust review, and the effects of the Change in Bank Control Act. However, the experience of 1977-81 and the subsequent divestitures to gain BHC status suggest strongly that the BHC form of ownership enjoys decided advantages. Among the most important of these is the ability to service debt more advantageously than an individual. Other important advantages of the holding company include the ability to engage in certain nonbanking activities and, in some cases, to expand geographically in ways not available through normal bank branching. Greater flexibility in structuring capital, ownership and control, and anti-takeover provisions also derive from the holding company form and provide important additional benefits.

FOOTNOTES

1. Table 1 includes one-bank and multibank holding company formations. Available aggregate data did not permit the segregation of the two types of formations by number, although experience indicates that except for the early 1970s nearly all of the formations recorded in this table consist of one-bank holding companies.

2. IRS regulations stipulate that a BHC must acquire at least 80 percent of the target bank to qualify for the tax treatment herein described.

3. More or less routine formations involving no serious financial, managerial, or competitive issues are normally approved by the 12 Reserve Banks under delegated authority procedures. More complicated cases are approved or denied by actions of the Board of Governors of the Federal Reserve System.

4. Few studies have been conducted on the importance of chain banking within individual states. One such study involving five midwestern states, however, identified 86 chain organizations controlling a total of 332 banks. Within these states, the various chain organizations controlled as little as 4.2 percent of state bank deposits and as much as 16.9 percent of bank deposits (see Joseph T. Keating, "Chain Banking in the District," *Economic Perspectives*, Federal Reserve Bank of Chicago, Sept./Oct. 1977, pp. 15-20).

5. *Mahaska Investment Co., Federal Reserve Bulletin*, Vol. 63 (1977), p. 579.

6. In the early 1970s the Board routinely considered pre-existing relationships as part of its analysis of proposed multibank holding company formations. The Board generally did not regard these pre-existing relationships as raising any competitive issues because in most instances the affiliated banks had been started *de novo* by principals of the applicant's lead bank.

7. *First Lincolnwood Corp.* vs. *Board of Governors of the Federal Reserve System* 560 F.2d 258 (7th Cir. 1977)

8. U.S. Supreme Court in *First Lincolnwood Corp.* vs. *Board of Governors*, 439 U.S. 234 (1978).

9. *Mid-Nebraska Bancshares, Inc.* vs. *Board of Governors*, 627 F.2d 266 (D.C. Cir. 1980)

10. The Herfindahl-Hirschmann Index is obtained by summing the squared market shares of deposits (or some other measure, such as assets or loans) of each banking organization in a market. The Department of Justice presently considers an index of 1800 or higher to comprise a high degree of concentration.

11. Ten of the twelve acquisitions were to be made by an exchange of shares and the assumption of acquisition debt ranging from $297 thousand to $2.9 million. In two other applications, no acquisition debt was involved, but the newly formed holding companies planned to borrow funds that were to be used as capital injections into the respective banks.

12. *First Monco Bancshares, Inc., Federal Reserve Bulletin*, Vol. 69 (1983), p. 293.

13. *Texas East BanCorp, Inc., Federal Reserve Bulletin*, Vol. 69 (1983), p. 636.

14. This law actually became effective in early 1979. The date of effectiveness explains why two of the affiliations (*Caneyville* and *Childress*) that occurred in 1978 and 1979 were, nonetheless, reviewed by the Board under the chain bank policy.